

FINANCIAL HISTORY

THE MAGAZINE OF THE MUSEUM OF AMERICAN FINANCE



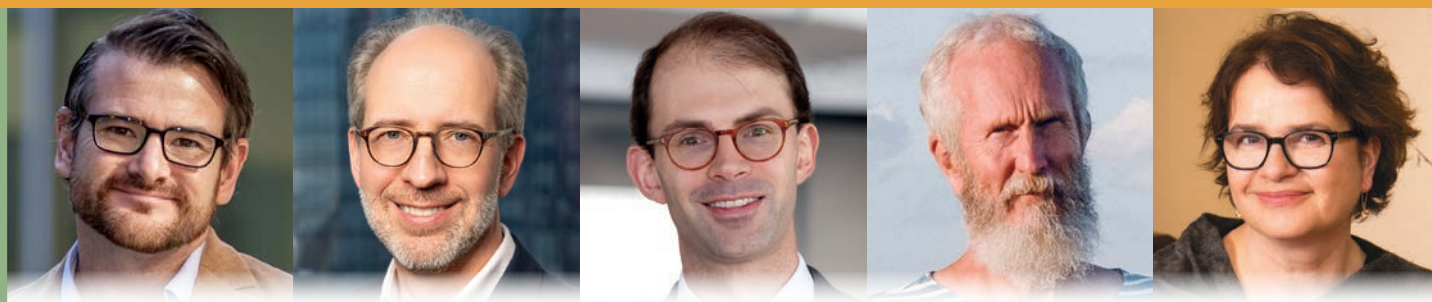
The Bears Seize Control: The 50th Anniversary of the 1970s Bear Market

A 45-Year Flood: The History of Alternative Asset Classes

100 Years of Mutual Funds

ISSUE 151 | FALL 2024

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- Sept 25** **Virtual Event:** Rob Lalka on *The Venture Alchemists: How Big Tech Turned Profits into Power*. Talk followed by Q&A. 12:00–1:00 pm. Registration required. In partnership with Fordham University Gabelli Center and CFA Society NY.
- Oct 10** **Virtual Event:** Philipp Carlsson-Szlezak and Paul Swartz on *Shocks, Crises, and False Alarms: How to Assess True Macroeconomic Risk*. Talk followed by Q&A. 12:00–1:00 pm. Registration required. In partnership with the Fordham University Gabelli Center and CFA Society NY.
- Oct 15–Nov 5** **Museum Finance Academy:** Free virtual series for 11th and 12th graders. Meets every Tuesday afternoon (classes offered in two time zones for national reach). Registration required; scholarships of \$500 and \$1,000 awarded to top achievers. Sponsored by Con Edison.
- Oct 24** **Virtual Event:** J. Doyne Farmer on *Making Sense of Chaos: A Better Economics for a Better World*. Talk followed by Q&A. 12:00–1:00 pm. Registration required. In partnership with the Fordham University Gabelli Center and CFA Society NY.
- Oct 26** **Annual Great Crashes Walking Tour:** Tour meets outside Alexander Hamilton US Custom House, One Bowling Green, NYC. 1:00–4:00 pm. Members free; general admission \$15.
- Oct 30** **In-Person Panel:** “Calling the Shots: Investing in Sports.” Sponsored by Bright Path and Broadridge. 6:00–8:00pm. Hearst Tower Theater, 300 West 57th Street on 8th Avenue, NYC. Program followed by reception. Space is limited; registration required.
- Nov 7** **Virtual Event:** Paulina Bren on *She-Wolves: The Untold History of Women on Wall Street*. Talk followed by Q&A. 12:00–1:00 pm. Registration required. In partnership with the Fordham University Gabelli Center and CFA Society NY.

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FINANCIAL HISTORY

THE MAGAZINE OF THE
MUSEUM OF AMERICAN FINANCE

*in association with
the Smithsonian Institution*

Issue 151 • Fall 2024
(ISSN 1520-4723)

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OF AMERICAN
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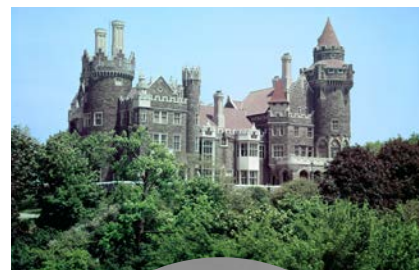
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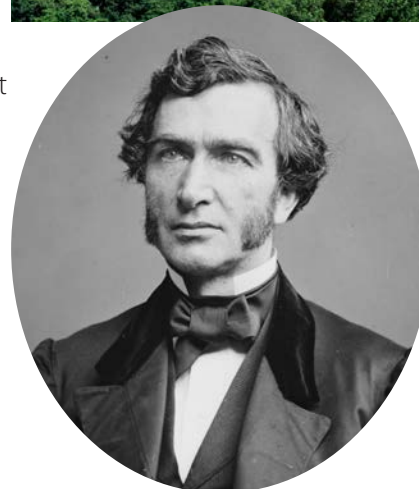
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MoAF Offers Free Virtual and In-Person Programs and Announces Plans for 2025 Gala

I AM PLEASED TO REPORT that in 2024, we have already reached several thousand students, adults and finance professionals with our educational and public programming, thanks in part to our many new and existing valued partnerships. This summer, we continued our partnership with the New York Public Library's Thomas

We continue to build our board of trustees and most recently welcomed Jorge Nario—head of the Fidelity Center for Applied Technology (FCAT)—to our board. Over the past year, we have developed a close relationship with FCAT, as they have participated in our programs and were a major sponsor of our 2024 Gala. In the last few months, trustees Ric Edelman, Mark Shenkman, Dick Sylla and I have visited their creative design space as we further the connection. In August, I was joined by Collections

on *Shocks, Crisis and False Alarms* (10/10); J. Doyne Farmer on *Making Sense of Chaos* (10/24); and Paulina Bren on *She-Wolves: The Untold History of Women on Wall Street* (11/7). In-person events include our annual Great Crashes Walking Tour (10/26) and the “Calling the Shots: Investing in Sports” panel (10/30). We invite you to attend any or all of these free events. If you are interested in watching any virtual programs that you may have missed (or re-watching the ones you particularly enjoyed), they will be available on our website at www.moaf.org/videos.

Looking ahead to next year, I am excited to announce plans for our 2025 Gala, which will be held at the Ziegfeld Ballroom on Thursday, March 6. Mark Carney, former governor of the Bank of Canada and the Bank of England and currently the chairman of Brookfield Asset Management, will receive the Whitehead Award for Distinguished Public Service and Financial Leadership. Our Lifetime Achievement Award will be presented to investing legend Peter Lynch, vice chair of Fidelity Management & Research. Stay tuned to our website for more details on this event, which will be released later this fall. \$



Message to Members

David J. Cowen | President and CEO

Yoseloff Business Center on our free financial education series for adults. The eight-part “Investing A to Z” virtual series ran from mid-July through early September. In addition, in July and August we ran our weekly virtual Museum Finance Academy @ NYPL series, which reached 550 teens and young adults from across the country.

The fall session of the Museum Finance Academy (MFA) is currently underway, with the top achievers earning scholarships ranging from \$500–\$1,000. This national program is offered in a virtual format in two time zones (Eastern and Central), and the fall session is sponsored by ConEdison.

Manager Sarah Poole and IT Manager Robert Dinkelman as we presented our “Origins of the Capital Markets” class at Fidelity’s Covington, Kentucky campus. We presented four different sessions to more than 300 employees. I am also honored to be the keynote speaker at FCAT’s Patents Award event on October 22.

Also this fall, we are in the midst of a busy events season, with programs offered in both virtual and in-person formats. Virtual programs—presented as part of the MoAF/Fordham Financial Issues Forum—include Rob Lalka on *The Venture Alchemists* (9/25); BCG Economists Philipp Carlsson-Szlezak and Paul Swartz



David Cowen presents the Museum's “Origins of the Capital Markets” class at Fidelity’s campus in Covington, Kentucky.

Museum adds the George M. Jones III Collection of Historical Securities to its Archive

By Sarah Poole, Collections Manager

THIS SUMMER, the Museum of American Finance received a significant donation to its collection as a bequest from George M. Jones III, who served on the Museum's board of trustees from 1999–2006. He was a passionate supporter of history, the arts and his local community in northwestern Ohio. The Museum was deeply saddened to learn that he passed away on February 15, 2023, at the age of 79.

The George M. Jones III Collection of Historical Securities includes more than 300 securities from the 18th through 20th centuries, spanning all of the major industries that have shaped the growth of the United States. Many of the certificates are signed by prominent figures, including early US Senators William Few (GA, also a signer of the US Constitution) and William Bingham (PA); industrialists John D. Rockefeller, J. Paul Getty and Jay Gould; and bankers J.P. Morgan, Henry Wells and William G. Fargo. The collection also includes a number of US and foreign government securities that illustrate

significant historical events, such as the American Revolution, the American Civil War and the reunification of Germany in 1989. There are also certificates representing some of the most notorious scandals in financial history, from the fictitious Kingdom of Poyais in the 1820s to the accounting fraud at Enron Corporation in 2001.

The most significant piece in the collection is a first-issue Standard Oil stock certificate issued to Henry M. Flagler on January 29, 1870. The certificate is serial number 16 and is signed by Flagler and John D. Rockefeller. This security is among the first issued after Standard Oil incorporated on January 10, 1870, with capital of \$1 million in \$100 shares. Known as “founders shares,” these early shares were only issued to the seven original corporate founders: John D. Rockefeller, William Rockefeller, Henry Flagler, Samuel Andrews, Stephen Harkness, Oliver Jennings and the Rockefeller, Andrews & Flagler Co.

As of 2020, only 10 known founders shares were held in private collections, including the one now in the Museum's collection. The shares mysteriously trickled

into the scripophily market from the 1960s to the 1990s. Collectors eventually learned that in 1966, a number of the founders shares were removed from the company archives at Exxon (the successor company to Standard Oil), framed and given to various officers for Christmas. It is estimated that a dozen more founders shares are unaccounted for.¹ The Museum is grateful for the opportunity to preserve one of these rare certificates for the purpose of public access to financial education.

The George M. Jones III Collection of Historical Securities is full of fascinating stories from financial history. Many of these stories are certain to play an integral role in future exhibitions and scholarship from the Museum of American Finance. The gift of this expansive collection will serve students and enthusiasts of finance and financial history for generations to come. \$

Note

1. A more detailed account of this fascinating story is available in “Scripophily of the Standard Oil Company,” by Max Hensley, in the April 2020 issue of *Scripophily*.



Above: Standard Oil stock certificate for 130 shares issued to Henry M. Flagler, 1870.

Right: Beautifully illustrated Compagnie des Installations Maritimes de Bruges certificate, 1904.



Why Kemmerer, Wyoming Matters: J.C. Penney and Bill Gates

By Brian Grinder and Dan Cooper

“Therefore, all things whatsoever ye would that men should do to you, do even so to them.”

— *The Golden Rule*
Matthew 7:12

WHAT DO J.C. PENNEY and Bill Gates have in common? The short answer is Kemmerer, Wyoming.¹

While the Federal Reserve prefers to meet once a year 170 miles north of Kemmerer in Jackson Hole², Kemmerer continues to play a surprisingly important role in the economic development of our country. It is currently playing a pivotal role in the development of clean nuclear energy, but 122 years ago, this coal mining town was the home of the first J.C. Penney department store.

James Cash Penny's business career and philanthropic activities were motivated by the Golden Rule, which endorses a lifestyle based on treating others as we would want to be treated. This principle was instilled in Penney by his father who was an Old School Baptist preacher.³ It was also the foundational idea behind the Golden Rule stores that began operating in the area around Denver, Colorado, in the late 1800s.

William Henry Gates III's philanthropic activities, especially in the area of clean energy development, are motivated by concerns over climate change. In *How to Avoid a Climate Disaster*, Gates writes, “To avoid a climate disaster, we have to get to zero [manmade carbon emissions].” Getting to zero without depriving developing countries of the energy they need to grow their economies can only be accomplished by developing and expanding nuclear plants that generate clean electricity with minimal nuclear waste. Gates argues that nuclear power “is the only



Portrait of James Cash Penney, who founded J.C. Penney in Kemmerer, Wyoming, in 1902.

carbon-free energy source that can reliably deliver power day and night, through every season, almost anywhere on earth, that has been proven to work on a large scale.”

At first glance, Penney and Gates appear to have little in common. Penney grew up in poverty on a farm in rural Missouri; Gates was the son of well-to-do parents in the Seattle area. Penney chose to start his business in Kemmerer, while Gates's interest in the small Wyoming town came later in life. Penney's philanthropic work focused on agriculture, while Gate's philanthropic work focuses on climate change, as well as education and global health.

Nevertheless, both men were hard workers who pushed their businesses relentlessly in the pursuit of growth and domination in their respective industries. Neither man originated the ideas they used to grow their businesses, but both capitalized on those ideas to grow their businesses and increase their personal wealth. Finally, Penney spent and Gates continues to spend significant amounts of time and money on philanthropic activities.



Bill Gates, whose philanthropic work on climate change recently led him to Kemmerer, Wyoming.

J.C. Penney and the Golden Rule Store

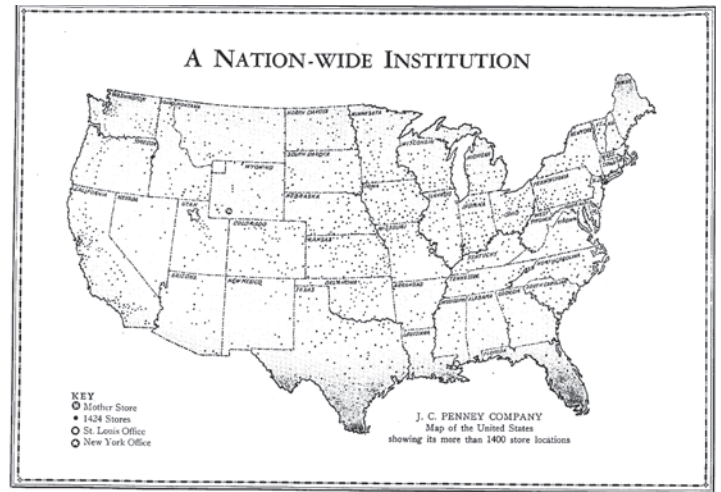
Although Penney loved life on the farm, he concluded “that there was little money in farming. In fact,” wrote Penney, “I could see no money in it and then, furthermore, even when I was a boy, I had hope and ambition—and I nursed it along—to become a wealthy man.” His dying father recognized that ambition in Penney and set him up to work as an apprentice with a local department store in Hamilton, Missouri. Penney, a hard worker and quick study, thrived in the department store business, but when the tuberculosis that took his father's life threatened his own, J.C. Penney chose to leave the humidity of Missouri for the drier climate of Denver, Colorado.

After a couple of false starts, Penney landed a job in Longmont, Colorado, at the Golden Rule Store owned and operated by fellow Missourian Thomas Callahan. Although there were many stores using the Golden Rule name, Callahan's new chain of stores had several

J.C. Penney Archives



The J.C. Penney store in Kemmerer, Wyoming, still named the Golden Rule Store before the 1913 name change.



J.C. Penney store location map, published in the May 1930 issue of *The Dynamo*.

advantages. First, they took the Golden Rule seriously, offering quality goods at low prices; second, as the chain grew, the stores formed a buying syndicate that gave them the ability to purchase inventory at lower prices than their competitors; and third, Callahan's plan for expansion involved offering the manager of a new store the opportunity to become a partner in that store. Callahan would put up two-thirds of the funds for the store, while the new manager put up the other one-third. Potential managers began by working in existing stores, where they were trained and evaluated as potential new partners.

Penney did well in Callahan's Longmont store and was soon asked to move to the Golden Rule store in Evanston, Wyoming, which was managed by William Johnson. Penney worked in Evanston for about three years before Callahan and Johnson offered him a partnership in a new store. Although Johnson urged Penney to open a store in Ogden, Utah, population 20,000, Penney argued that Ogden was too big and opted to start the new

store in the small mining town of Kemmerer, Wyoming, population 900.

On April 14, 1902, Penney opened his first Golden Rule store in a 25' x 45' building in downtown Kemmerer. According to Penney biographer Mary Elizabeth Curry, Penney, his first wife Betha and their young son Roswell lived above the store in the attic "using shoe boxes for chairs and other packing cases for tables."

Kemmerer was a huge risk for young Penney. Others had tried and failed to open similar stores there but were unable to compete with the company store, which offered credit to mine workers. Any debt accrued at the company store was deducted from the miner's future paychecks. This left miners in a state of perpetual indebtedness to the company store. Since most mining towns were in remote areas with no competition, company stores charged high prices and sold low-quality goods. The Golden Rule's cash and carry policy kept Penney's customers out of debt, while offering reasonably priced high-quality goods. Penney also offered unusually good

customer service. He not only knew all of his customers by name, but he also memorized their clothing sizes. This was very convenient for customers who came in to shop for their spouse but had forgotten their shoe or shirt size.

Penney soon opened two more stores in Rock Springs and Cumberland in partnership with Callahan and Johnson. In 1905, Callahan and Johnson had a serious falling out and ended their partnership. Penney bought out his partners in January 1906 and became the sole owner of three Golden Rule stores. These stores became the foundation of the J.C. Penney Company, the nation's first transcontinental department store.

Penney added new stores quickly using the two-thirds/one-third ownership model with his new store managers. Penney's long-term goal was to open at least 50 stores. He accomplished this in 1914. By 1930, there were more than 1,400 J.C. Penney stores throughout the United States.

In 1909, Penney moved the headquarters of his business to Salt Lake City and



The J.C. Penney Company mother store, founded in 1902.

in 1914 moved the company headquarters to New York City.⁴ Although the company was experiencing phenomenal growth and financial success, Penney was working himself to death. In early 1917, at the advice of his doctor, Penney resigned as president of the company and became chairman of the board of directors.

With more time on his hands, Penney decided to indulge his passion for farming by buying a small farm north of New York City, which he named Whitehaven. His return to farming sparked an interest in agricultural philanthropy. This entailed purchasing 120,000 acres in northern Florida, where he began a cooperative

farm community, an Institute of Applied Agriculture and a retirement village for pastors and other religious workers. Although well-intentioned, Penney's philanthropic activities in Florida, along with an untimely investment in a Florida bank, would be his undoing in 1929.

Although the J.C. Penney Company fared well during the Great Depression, Penney was plunged into a deep financial crisis that wiped out his entire \$40 million fortune. In the next *Educators' Perspective*, we will take a closer look at Penney's philanthropic activities before and after the financial crisis he endured during the 1930s. \$

Brian Grinder is a professor at Eastern Washington University and a member of Financial History's editorial board. Dr. Dan Cooper is the president of Active Learning Technologies.

Notes

1. Residents of Kemmerer pronounce it "Kemmer." Penney biographer David Kruger, in a lecture at the Flagler Museum in Palm Springs, Florida, said he was told by residences of Kemmerer that, "We only stutter when we write it."
2. The Federal Reserve has never met in Kemmerer.



Statue of J.C. Penney in Kemmerer, Wyoming.

3. Since Old School or Primitive Baptists refused to pay their ministers, Penney's father was forced to engage in farming as a means of making a living.
4. Curry cites the following reasons for the move to NYC: "Among the many advantages of being near vendors and in the market daily were special bargains, discounts and more fashionable merchandise." Furthermore, the move east would help the company "become more credible in financial circles."

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A 45-Year Flood

The History of Alternative Asset Classes



Wayne Miller / Magnum Photos

By Mark J. Higgins

OVER THE PAST SEVERAL DECADES, institutional investment plans have substantially increased allocations to alternative asset classes, such as private equity, hedge funds, private real estate and private credit. According to data collected by Equable, public pensions alone have increased alternative asset class allocations from a mere 9.3% in 2001 to 33.8% in 2023.

The thesis underpinning the shift into alternatives is that, despite much higher investment management fees and illiquidity, investors can anticipate sufficient off-setting benefits in the form of reduced portfolio volatility and return enhancement. The problem, however, is that multiple studies reveal that these benefits have

fallen short of expectations. Moreover, the fundamental dynamic of the alternative asset class investment cycle strongly suggests that future benefits will become even more elusive. Understanding the history of these investments helps explain why this is the case.

Institutional Plans End America's Capital Drought

"We cannot depend safely for an indefinite period of time on the expansion of our big old industries alone... We need to marry some small part of our enormous fiduciary resources to the new ideas which are seeking support."

**—Ralph Flanders, president
of the Federal Reserve
Bank of Boston (1945)**

In the spring of 1979, Ian Lanoff, administrator of pension and welfare programs at the US Department of Labor (DoL), was summoned to the White House. He

later recalled that it was the only such invitation he received during his five-year tenure. When Lanoff entered the meeting, he noted the presence of several well-known politicians and financial executives. Their singular goal was to end the capital drought that constrained funding for many of the nation's most promising entrepreneurial ventures.

The root of the capital shortfall can be traced to the Allied victory in World War II. The demands of war accelerated technological innovation in the United States. Once combat operations ceased in the summer of 1945, American companies saw an opportunity to commercialize many inventions. But the biggest obstacle was obtaining capital. Commercial banks, which remained scarred by the Great Depression, considered such ventures too risky. This prompted the formation of the nation's first venture capital (VC) firms to fill the void.

Initially, wealthy individuals were the primary sources of funding for VCs, but by the late 1970s, their resources were stretched thin. In contrast, institutional investment plans, such as pension funds, foundations and endowments, had an

The individuals in this photograph are known as the "traitorous eight." Pictured from left to right are: Gordon Moore, C. Sheldon Roberts, Eugene Kleiner, Robert Noyce, Victor Grinich, Julius Blank, Jean Hoerni and Jay Last. After leaving Fairchild Semiconductor in 1957, they played critical roles in the rise of Silicon Valley and the venture capital industry.

A Fatal Flaw of America's First VC Firm

“If one of our companies is suddenly in need of \$25,000, we can do nothing about it. We have to go to our lawyers...and it may be sixty days or more before we get an answer. By that time a small company, as you know, can become very, very dead.”

**—Georges Doriot, co-founder of ARD
(letter to Ralph H. Demmler, chairman of the SEC)**

In 1946, a group of leading academics, financiers and industrialists founded Advanced Research and Development (ARD), which was the first private venture capital (VC) firm in the United States. Under Georges Doriot's leadership, ARD blazed the path for the emerging profession. But unlike modern VCs, ARD was structured as a closed-end investment company and was thus subjected to SEC regulation.

ARD's structure ultimately proved untenable because SEC regulations failed to accommodate many fundamental aspects of venture investing. Examples included limits on incentive compensation for fund employees and caps on ARD's permissible ownership percentage in portfolio companies. Doriot battled constantly with the SEC to obtain waivers, but ultimately, the investment company structure was unworkable. Textron Corporation acquired ARD in 1972, and its influence waned.

Despite ARD's demise, Doriot proved the viability of VC investing, and several of his proteges launched firms of their own. But having witnessed ARD's struggles with the SEC, they structured their funds as limited partnerships. This provided the flexibility they needed to fund early-stage ventures, several of which would become the largest corporations in the United States.

abundance of capital. The only problem was that most trustees refused to invest in VCs because they feared that it violated the DoL's interpretation of the Prudent Man Rule under the Employee Retirement and Income Security Act (ERISA) of 1974. The law stated that trustees must discharge their duties “by diversifying the investors of the plan so as to minimize the risk of large losses.” Most trustees interpreted “the risk of large losses” as an implicit ban on VC funds, which invariably invested in many companies that were likely to produce large losses. Fear of ERISA violations forced trustees to stick with traditional funds that invested in high-quality bonds and stocks. Trustees of non-ERISA plans, such as public pensions, adopted similar

policies out of an abundance of caution. This starved VCs of desperately needed capital throughout the 1970s.

Under pressure from its membership, the National Venture Capital Association (NVCA) lobbied Congress to help end the capital drought. These efforts paid off, and on June 21, 1979, Lanoff announced a shift in the DoL's interpretation of the Prudent Man Rule, stating, “Although securities issued by a small or new company may be a riskier investment than securities issued by a blue-chip company, such an investment may be entirely proper under ERISA's prudence rule.”

No longer impeded by ERISA, trustees opened the spigots for VC funds. For the three-year period ending in 1977, VCs

raised a mere \$60.4 million. Over the next three-year period, they raised nearly \$800 million. But VCs were not the sole beneficiaries of the new DoL guidance. The limited partnership model that VCs embraced was soon replicated by former investment bankers to form the first buyout funds. Thus began a 45-year flood of capital into areas of the market that are collectively referred to as alternative asset classes.

Beautiful Decade for a Leveraged Buyout

“I am not a destroyer of companies. I am a liberator of them. The point is, ladies and gentlemen, that greed, for lack of a better word, is good.”

**—Gordon Gekko
in Wall Street (1987)**

In 1982, Federal Reserve Chairman Paul Volcker's legendary monetary tightening campaign ended the grueling, 17-year period known as the Great Inflation. The return of price stability also created a once-in-a-lifetime opportunity for another alternative asset class. Investors referred to these funds as leveraged buyout (LBO) funds, buyout funds or sometimes simply private equity funds.

The objective of a buyout fund was simple. Fund managers purchased companies using mostly debt and a small amount of equity. Then, they aggressively repaid the debt by selling non-strategic business units, eliminating extraneous costs and improving strategy and operations. After a few years, the fund would sell its entire position—often for a much higher multiple than the one applied at the time of purchase. The first buyout funds emerged in the late 1970s and 1980s and included firms such as Forstmann Little, Kohlberg Kravis Roberts (KKR) and Thomas H. Lee Partners.

Conditions in the 1980s were ideal for buyouts. First, the cost of debt steadily declined throughout the decade due to Volcker's victory over inflation. Second, price/earnings ratios of publicly traded firms increased, as lower inflation reduced the required return for equity investors. Finally, many companies were laden with inefficiencies due to the habitual practice of overdiversifying throughout the 1960s and 1970s. In combination, these factors provided buyout funds with an extraordinary

opportunity to generate exceptional returns.

With gale force winds at their backs, buyout funds produced gargantuan returns in the 1980s. For example, in 1983, KKR claimed to be generating an average annual return of 62.7% on its investments. But, as is always the case, exceptional returns attract a stampede of followers. By the 1990s, private equity firms were inundated with far more capital than they could deploy responsibly. Ted Forstmann, who was one of the more disciplined buyout managers, lamented the consequences, stating, “In the beginning, the innovators of this idea, of whom I was one, had a great deal of discipline... What has happened is imitators flocked in, discipline has eroded, and as a result, breakups that didn’t make sense have occurred.”

Forstmann didn’t have a name for it, but he was observing the late phase of a typical, alternative investment cycle.

New Haven for Unconventional Investing

“By operating in the institutional mainstream of short-horizon, uncontroversial opportunities, committee members and staff ensure unspectacular results.”

*—David Swensen, late CIO
of the Yale Investments Office*

In 1985, James Tobin and William Brainard approached David Swensen with an unsolicited offer to return to Yale

University to oversee its endowment. At the time, Swensen was a rising star at Lehman Brothers, where he established a reputation as an innovative financier. He initially hesitated to accept Yale’s offer, as he feared he lacked the necessary experience. But his love of Yale, deep sense of mission and natural talent for teaching outweighed his concerns.

Soon after returning to New Haven, Swensen invited his friend and fellow alum, Dean Takahashi, to join him. At the time, Yale’s portfolio was invested primarily in publicly traded stocks, bonds and cash. Swensen and Takahashi believed the allocation was suboptimal considering Yale’s long-term return objectives, higher-than-average risk tolerance and limited liquidity constraints. They crafted a new,

The Return of the Stock Operators

“We may as well tell the truth and put the blame where it belongs.

It’s up to Washington now. We have stepped aside... Eventually we will take control again.”

—William C. Durant (October 1929)

The stock operators who dominated Wall Street prior to the 1930s wielded a formidable weapon known as the stock pool. Under a pool arrangement, a group of investors consolidated their financial resources. Then, they appointed a pool manager who would use all sorts of nefarious techniques to manipulate the price of a stock to their benefit. But the stock pool disappeared after it was outlawed by the Securities Exchange Act of 1934.

William Durant, the famed stock operator, foresaw this outcome soon after the Great Crash of 1929, but he predicted that someday the stock operators would resurrect the stock pool. In 1992, his prophecy came true when the flawed mechanics of the European Union (EU)’s exchange rate mechanism (ERM) created a legal application of this forgotten market manipulation technique.

The ERM was intended to keep EU member currencies trading within a narrow band, but maintaining the band required periodic central bank intervention. In 1992, the pound sterling depreciated too far relative to the German mark. The Bank of England (BoE) purchased pounds aggressively to prop up its value. Observing the BoE’s efforts, co-founders of the Quantum Fund, George Soros and Stanley Druckenmiller, calculated that

the BoE lacked sufficient foreign exchange reserves to remain in the ERM. If the BoE failed, they would abandon the ERM, which would cause the pound sterling to depreciate sharply.

Soros and Druckenmiller knew that shorting the pound promised enormous profits, but it required selling pressure that was beyond their ability. They addressed this problem by sharing the plan with several hedge fund managers, and the group formed a virtual stock pool to short the pound. As predicted, massive selling pressure forced the BoE to abandon the ERM. After covering their short position, the Quantum Fund alone made a \$1.5 billion.

Wall Streeters were awed by the profits but were even more excited about the return of the stock pool. The “Breaking of the Bank of England” triggered rapid growth of hedge fund assets under management (AuM). In 1990, hedge fund AuM was less than \$10 billion. By 2000, it exceeded \$250 billion. But unlike buyout and VC funds, hedge fund growth was driven primarily by a fleeting opportunity. The resurrection of the stock pool was an anomaly that was not expected to last. Nevertheless, once the stock operators regained a foothold, they refused to yield. In 2024, hedge funds hold more than \$5 trillion of AuM.

The Neglected Cost Discipline of the Prudent Investor

“A trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee...

Wasting beneficiaries’ money is imprudent.”

—Uniform Prudent Investor Act (UPIA)

In 1994, the National Conference of Commissioners on Uniform State Laws approved the Uniform Prudent Investor Act (UPIA) and recommended enactment by the states. By December 31, 2023, nearly 50 states had codified the UPIA into law.

A key component of the UPIA is the application of the Prudent Investor Rule. Most trustees embrace the diversification principles implicit in the UPIA’s interpretation of the Prudent Investor Rule, but few appreciate the cost principles. Yet, as revealed in the above quote, cost management is a critical responsibility that is clearly articulated in the UPIA.

Evaluating costs is especially important for trustees who enter the opaque and expensive realm of alternative investments. Fees in these asset classes far exceed those charged by actively managed funds in traditional asset classes, much less low-cost index funds. For example, VC and private equity funds routinely collect a 2% management fee and 20% of profits above a specified return hurdle. Over the life of such funds, fees can easily exceed more than 3% per year.

For nearly 30 years, few trustees have questioned whether the benefits of alternative investments are worth the incrementally higher costs—even as mounting evidence consistently reveals they are not. For example, in June 2024, the Boston College Center for Retirement Research published a paper that cited four studies, all of which concluded that the average public pension plan substantially underperformed a passively managed portfolio with comparable exposures.

unconventional strategy that included a heavy equity bias, highly selective use of active managers and larger allocations to VC and buyouts.

The strategic shift was innovative and extremely well-executed, but it also benefitted from fortuitous timing. Swensen and Takahashi were early allocators to VC and buyouts, and they also benefited from a shift to higher equity exposure at the front-end of an extended bull market. Luck does not diminish their

overall achievements—the Yale team has also consistently selected high-performing active managers—but it amplified their performance advantage.

Consultants Open the Floodgates

Yale’s unconventional strategy was highly successful. For the 13-year period ending June 30, 2000, the Yale endowment returned approximately 15.7% per year versus approximately 11.6% for the median endowment.

Performance like this was impossible to hide. In 1997, Professor Josh Lerner published a Harvard Business School case study profiling Yale’s strategy. Three years later, Swensen shared even more detail in his seminal book, *Pioneering Portfolio Management*.

Tragically, most investment plan trustees—and especially the investment consultants who advise them—misinterpreted Swensen’s advice. They concluded that blunt allocations to VC, buyouts and hedge funds were the sole driver of Yale’s performance. Few appreciated that it was the rare strength and stability of the people making the decisions that constituted the true secret of their success.

Over the subsequent 25 years, endowments, foundations and public pension plans substantially increased allocations to alternative asset classes. Nearly all were oblivious to the fact that the flood of capital all but guaranteed subpar returns for most investors.

The Alternative Asset Class Cycle is Revealed

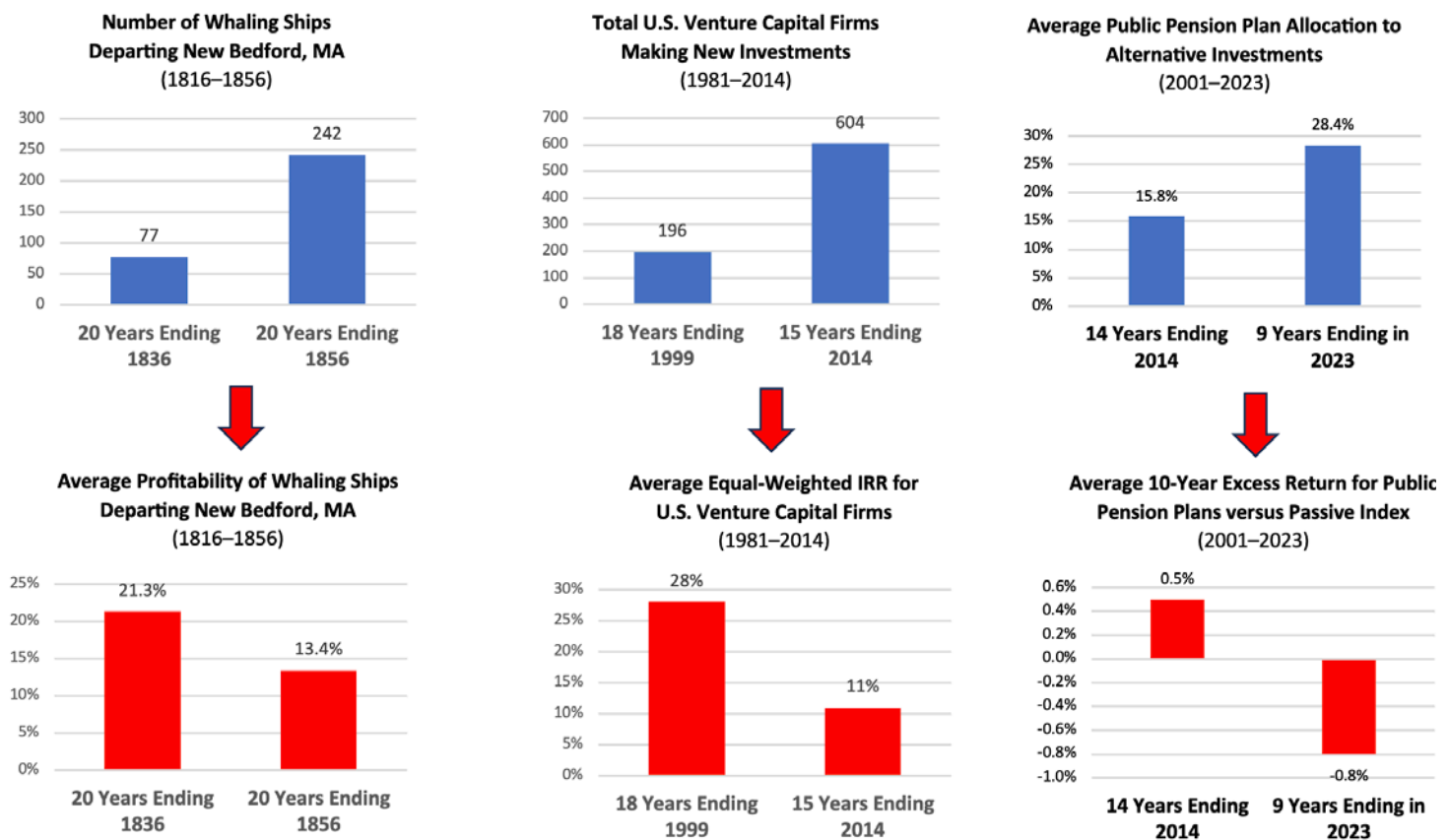
“Until 1858, every year saw an increase in the number of ships devoted to whaling; but the great numbers of whale hunters had done in the sea something very like that which other hunters afterward perpetuated on land. The herds of whales had been decimated.”

—Boyden Sparkes and Samuel Taylor Moore (1930)

The passage of 45 years has revealed the fundamental dynamics of the alternative investment cycle. It begins with the opening of a temporary void in capital markets. For example, the demand for startup capital after World War II prompted the formation of the VC industry and the end of the Great Inflation triggered the rise of buyouts. When these voids appear, capital providers have a real, but temporary, opportunity to generate above average returns because demand for capital far exceeds supply. But the supply/demand imbalance eventually reverses with the passage of time.

The next phase begins after peers witness the returns of early adopters and

FIGURE 1: Dynamics of the Alternative Asset Class Cycle for Whaling, VC and Public Pension Plans



Note: The 10-year average excess return versus a passive index for public pensions for the 14 years ending in 2014 includes five data points for the 10-year periods ending in 2010–2014.

Sources: Equable (2024); Aubry, Jean-Pierre and Yimeng Yin. 2024. “How Do Public Pension Plan Returns Compare to Simple Index Investing?” Issue in Brief 24-13. Chestnut Hill, MA: Center for Retirement Research at Boston College; Mark Higgins. “A Whale of a Tale: The History of Venture Investing in the United States.” *Financial History*. Fall 2023.

flood the asset class with capital. Within a few years, the supply of capital exceeds demand, which compresses future returns. But unlike the ebb and flow of publicly traded equity valuations, alternative asset classes become trapped in the late phase for many years. It may take several decades for allocators to appreciate that the supply and demand imbalance renders all but the most talented managers unable to produce returns that justify the corresponding fees, risk and illiquidity. Figure 1 shows the impact of the alternative asset class cycle on modern VC investors and 19th century whaling investors. It also shows how it has played out with 21st century public pension plan investors in multiple alternative asset classes.

A tell-tale sign that an alternative asset class cycle has entered the late phase

is when fund managers shift their sales pitches from “excess return” to “diversification.” This happened for buyout funds and hedge funds by the end of the 20th century, and it is now happening with the latest investment fad: private credit.

In the mid-1970s when investors began catching on to the dim prospects of active management, the founder of Eaton and Howard cynically advised his peers to embrace a new marketing pitch, declaring, “Well, fellows, when it comes right down to it, mutual funds offer the public only two things: First diversification of investments and second professional management. When times are difficult, as they are now, we should stress diversification.”

If trustees listen closely to the consultants, advisors and staff surrounding them, they will hear a similar siren song. These

voices often highlight the value of additional diversification without mentioning the imprecision of the asset class assumptions upon which such benefits depend. They tempt trustees with the promise of return enhancement without demonstrating that they possess the rare skills to capture it. Nevertheless, many trustees blindly accept the claim that investments in buyouts, VC, hedge funds and private credit are more likely to add value than destroy it.

In 2024, nearly all alternative asset classes reside squarely in the late phase of their distinct life cycle. More than 80% of public funds allocate to alternative asset classes, and the average allocation is roughly 34% of their portfolios. Few trustees realize that this is not a sign of an attractive opportunity—it is a red flag

Use and Abuse of Modern Portfolio Theory

“You don’t want to be average; it’s not worth it, does nothing. In fact, it’s less than the [public] market. The question is ‘how do you get to first quartile?’ If you can’t, it doesn’t matter what the optimizer says about asset allocation.”

—Allan S. Bufferd, treasurer emeritus, MIT (2008)

In 1990, Harry Markowitz received a Nobel Prize in Economics for his pioneering work on portfolio management. Dubbed Modern Portfolio Theory (MPT), Markowitz’s research demonstrated how investors could improve risk-adjusted returns by diversifying their portfolios among investments with imperfect return correlations.

Markowitz’s Nobel Prize coincided with an era of rapid growth for investment consulting firms. Many firms started by offering only investment performance reporting to institutional plan trustees, while bank asset management departments provided discretionary advisory services. Over time, consultants revealed that banks often produced lackluster performance and charged relatively high fees. Throughout the 1970s and 1980s, consultants convinced trustees to abandon banks and construct multi-manager portfolios with increasingly complex allocations. MPT was the tool that consultants used as a basis for their recommendations.

By the turn of the 21st century, MPT-based models were stretched far beyond their limits. The issue was that the utility of the output depended on the accuracy of return, volatility and correlation assumptions. But these assumptions were and always will be subject to a high degree of imprecision. While MPT models can help trustees visualize risk/return tradeoffs at a high level, they are far too imprecise to provide value in niche asset classes, such as alternative asset classes.

Abuse of MPT has intensified in recent years. Struggling to differentiate from competitors, many consulting firms concoct dozens of asset class assumptions that are highly misleading at best. This is especially problematic with alternative asset classes because expected returns are further distorted by the exceptional returns realized in the early phase of the cycle. Even more importantly, success in alternative asset classes is largely a function of skill, the presence of which is vitally important when an asset class is flooded with capital. Therefore, the most important metric to guide alternative asset allocations is the track record of the firm or person recommending them. But unlike the capital being deployed, such information is usually in short supply.

indicating that the opportunity has largely expired. In the late phase of the alternative asset class cycle, sufficient rewards only accrue to a small cohort of highly skilled investors. Trustees considering entry or expansion into these asset classes must ask whether the track record of their advisors is sufficiently robust to warrant such adventures. This raises another formidable challenge. Few consultants bother to calculate their track records, and those who do are unlikely to share them because they justifiably fear it will reveal the absence of skill rather than the presence of it. \$

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MORAL HAZARD

An Historical Comparison Between the United States and Canada

Archives of Ontario

By Joe Martin and Phyllis Scully

MORAL HAZARD is embedded in both the American and Canadian financial systems. Yet the timing and implementation was very different. Within interventionist economies, moral hazard exists as financial institutions share the burden of risk beyond their organization. Moral hazard suggests that actors will behave recklessly

Casa Loma—a castle built in Toronto from 1911 to 1914—was the residence of financier Sir Henry Pellatt. Pellatt went broke after the Home Bank failure of 1923 when there was a call for deposit insurance. This was the last bank failure in Canada until 1983.

if they are aware they will not be left entirely responsible for facing the consequences of their actions. The existence of deposit insurance, a “lender of last resort” and government intervention in the wake of a crisis suggest the presence of moral hazard at the core of a financial system.

Moral hazard can be limited through the acknowledgment of its existence in which institutions are rigorously supervised with little room for risk or innovation. It too can be limited through an entirely free market in which there is no government intervention. In this case, there could be no moral hazard as the government’s role would not include the bailing out of failing institutions.

Canada embedded Hamiltonian principles into its financial system from the beginning. The United States did not share the same dedication to limiting moral hazard and, instead, allowed for periods of deregulation and financial innovation which have been both fruitful and seeded with risk and instability. The American financial system is “fragile by design,” as Columbia University Professor Charles Calomiris has written. The First and Second Banks of the United States were both dissolved after facing political scrutiny, which left the United States with a decentralized banking system for much of the 19th century. Canada, on the other hand, recognized the need for central control

of the banking sector. They introduced the Bank Act of 1871 and adopted a uniform banking system that allowed for the chartering of banks with federal oversight. Ultimately, central control of the banking system came to fruition for both countries; however, their paths were very different.

Differing Attitudes Toward Moral Hazard

The presence of moral hazard in the United States became increasingly apparent in the response to bank failures in the 19th century. Until the National Bank Act was passed during the Civil War, the American system was comprised exclusively of state-chartered banks, which created a lack of uniformity and inconsistent standards. In Canada, the opposite was true and the banks in the different colonies—e.g. Nova Scotia, Upper Canada—all had a broader mandate and a branch banking system.

This time period was characterized by a series of crises, starting in 1837. The crises normally were the result of declining land prices, after a period of rapidly increasing prices and instability in the railroad/railway industry. In 1837, there was the additional factor of President Andrew Jackson vetoing the re-chartering of the Second Bank of the United States. In the aftermath of the Panic of 1837, Congress established the Independent Treasury System in an effort to separate federal funds from private banks. Although this was a signal of a hands-off approach which was meant to curb moral hazard by incentivizing banks to maintain sound practices, it would not be possible to maintain this approach forever.

Further crises occurred in 1857 and 1873 and led to further intervention. Even before the 1837 crisis, certain states adopted a system of deposit insurance, led by New York State in 1829. Between 1831 and 1858, five additional states adopted insurance programs: Vermont, Indiana, Michigan, Ohio and Iowa. Regulation varied from state to state; Indiana was recognized as having the best regulation. The arrival of “free banking” and the passage of the National Bank Act of 1863 during the Civil War led to the temporary end of the state sponsored insurance programs.

A total of 150 proposals for deposit insurance or guaranty were made in Congress between 1886 and the establishment of the Federal Deposit Insurance Corporation in

1933. Although not adopted, the early proposals signaled a shift in sentiment regarding government responsibility in the banking sector. The proposals suggest the early development of moral hazard as deposit security was no longer viewed as the sole responsibility of the bank.

As deposits became more important to banks than notes, eight states once again adopted deposit insurance. Between 1907 and 1917, the seven states running north from the Gulf of Mexico to Canada, plus Washington, did so.

Things were different in Canada. When the new country finally adopted a Bank Act in the early 1870s, it emphasized soundness in the banking system from the time of chartering (capital requirements, limits on bank liability and double liability for shareholders, as well as the unique Canadian provision of decennial reviews of the Bank Act and the banks). The legislation made clear that the banking industry—not the Canadian government—was responsible for any failures.

The bias to bank responsibility rather than government responsibility can be seen in the creation of the Canadian Bankers Association (CBA) in 1890 after the decennial Bank Act review. Cooperation of individual banks was facilitated and encouraged. A decade later, the CBA’s powers were enhanced and they became the regulatory agency of banking for more than the next two decades.

Evidence of the Canadian government not exposing itself to moral hazard can be found in the half century after confederation. During that period, 25 banks failed. The elimination of weaker banks or their amalgamation with more stable institutions was seen as a progressive move towards greater efficiency. The four major banks developed a two-fold strategy of organic growth and growth by acquisition of smaller, weaker banks. This is not dissimilar to what occurred in California, the only state with the same tendency towards larger and fewer banks as in Canada, but with better regulation in California.

The 1907 Crisis—More Differences

Intervention sets a precedent for more intervention and embeds moral hazard into the banking system. The aftermath of the Panic of 1907 influenced the way financial crises would be addressed in the United States. When J.P. Morgan saved

the Street in 1907, it was the last entirely private bailout during a major financial crisis, and it was followed by the introduction of the Aldrich-Vreeland Act, which allowed banks to issue emergency currency as a replacement for gold. Granting banks the ability to bypass gold convertibility and issue emergency currency in times of crisis embedded moral hazard deeper in the American financial system, as banks realized they no longer had to follow the rules of the game. Instead, in times of crisis there would be *new* rules.

In 1910, a meeting took place at Jekyll Island, Georgia, in which several influential bankers and financial leaders, including Senate Finance Committee Chairman Nelson Aldrich, met in secrecy at the Jekyll Island Club. This meeting led to the establishment of the Federal Reserve System. Several proposals were debated including the introduction of a lender of last resort, regulated member banks and a more elastic currency. The banking leaders could benefit from the introduction of a lender of last resort, as they would have the ability to take risk without bearing full responsibility.

In further response to the Panic of 1907, in 1913 the Federal Reserve Act was introduced, and 12 regional banks became responsible for the reserves and liquidity of member banks. The introduction of the Federal Reserve Act and the Aldrich-Vreeland Act set precedent that in the wake of a crisis, the government would be there with plans of further intervention. As the lender of last resort, the Federal Reserve Bank established a set of circumstances in which intervention was necessary. As soon as a lender of last resort exists, banks no longer believe they will be left to their own devices in times of crisis and will adjust risk tolerance accordingly. The establishment of the Federal Reserve cemented moral hazard into the American financial system.

Canada was also hit by financial stringency in 1907, but not as hard as the United States (−7.8% in GDP per capita in Canada vs −9.8% in the US). Canada’s saviour was not a J.P. Morgan-type figure, but rather the Federal Minister of Finance, W.S. Fielding. His solution to the problem of limits on bank note circulation was to increase their circulation for a specific period of time in order to provide the required liquidity during harvest season. This “gentle intervention” was all that



The Jekyll Island Club House in Georgia, site of the secret 1910 meeting of influential bankers and financial leaders, including Senate Finance Committee Chairman Nelson Aldrich, which led to the founding of the Federal Reserve Bank.



From left: Vice President John Nance Garner and President Franklin Delano Roosevelt, with First Lady Eleanor Roosevelt, Secretary of Agriculture Henry Wallace, Attorney General Homer Cummings and Secretary of State Cordell Hull, 1934. President Roosevelt and Vice President Garner initially disagreed on deposit insurance, with Roosevelt opposed and Garner in favor of implementing it.

Library of Congress

was required to re-establish the flow of credit. The banks knew that if they went beyond the limits, they—not the people of Canada—would bear the consequences.

The Introduction of Deposit Insurance (1933)

Twenty years after the establishment of the Federal Reserve came the greatest depression in American history. Many banks were engaged in speculative investments and lax lending practices, as precedent suggested the government would be there to intervene if the crisis warranted. It was not left to private institutions to rectify the Great Depression. In 1932, President Herbert Hoover introduced the Reconstruction Finance Corporation (RFC), which issued securities guaranteed by the government that would be lent to organizations experiencing liquidity issues. In times of crisis, these organizations could rely on the government to assist.

In response to the Great Depression, discussions of establishing Federal Deposit Insurance began and FDR wrote in a 1932 letter to the *New York Sun* that deposit insurance “would lead to laxity in bank management and carelessness on the part of both banker and depositor.” The future President—Franklin D. Roosevelt—even acknowledged that the introduction of deposit insurance would incentivize banks to act more recklessly. Why then—if the

President of the United States, as well as his Secretary of the Treasury, William H. Woodin, were initially opposed to deposit insurance—did it become law? It became law because Vice President John Nance Garner III, one of the President’s chief advisors, was a risk-averse banker from Texas—a state which had deposit insurance.

While President Roosevelt opposed deposit insurance, he supported a four-day banking holiday, which began two days after his inauguration, on March 6, 1933. The Banking Act of 1933 was introduced later that year, enabling the government to regulate and reorganize the banking system, provide financial aid to solvent banks and issue new currency. It also introduced the Federal Deposit Insurance Corporation (FDIC).

The FDIC was officially established in 1934 and created a shift in the allocation of resources and incentives for the banking industry, as banks were no longer as subject to the threat of a run, thanks to their newfound protection. Deposit insurance shifted the onus onto the FDIC to protect depositors and allowed more room for banks to take risks, as moral hazard became increasingly enmeshed in the system.

Canada faced an even worse Great Depression than the United States. This was not helped by the Smoot-Hawley Tariffs, which saw Canadian exports to

the United States decline by 55% between 1930 and 1932. In 1930, Canada had elected as Prime Minister a self-made multi-millionaire, R.B. Bennett, who had been legal counsel to the Royal Bank of Canada, as well as a member of its Board of Directors from 1927 to 1930 and a major shareholder.

Bennett was faced with an entirely different situation than the one facing President Roosevelt. Where 9,000 American banks failed between 1900 and 1930, no Canadian bank failed in the six decades from 1923 to 1983. As Richard N. Langlois writes in his recent opus about the introduction of deposit insurance in the United States, “More than 80% of the failed banks were small state-chartered outfits, the obvious way to prevent further crises would have been to do away with the fragmented unit-banking system by allowing national branching. Canada, which had only 10 banks but nearly 4,000 branches, had had no failures.”

There is no evidence that Bennett ever considered introducing deposit insurance, although there is ample evidence that he was concerned about Canadian banks. Instead, he appointed a Royal Commission to conduct a Review of Banking and Currency in Canada in place of the normal decennial review. Lord Macmillan, a British peer, chaired the commission, which also included one other Englishman and three Canadians, but no Americans. On a 3–2 vote, the commission voted in favor



R.B. Bennett, Prime Minister of Canada from 1930–1935, opens the Canadian National Exhibition in Toronto, August 26, 1932.

of creating a privately owned central bank. The two most knowledgeable Canadians voted against its creation.

The approach to banking in the United States and Canada is often compared and contrasted. A key consideration in this discourse revolves around the trade-offs between fostering innovation and competition, versus mitigating moral hazard through regulatory measures. One must consider whether to endorse a system that prioritizes bank innovation and competitive growth, albeit with a tendency toward government bailouts during crises, or to support a regulatory framework that seeks to address moral hazard but potentially stifles innovation and competition.

The United States chose banking innovation and competitive growth and has maintained its status as the leader in the global financial system and seen fruitful results. However, the country has also been rewarded with crisis and a burden on the taxpayer to bail out the system.

Canada chose to place the onus on the bankers and the banking system from the beginning until the late 1960s, and it has remained one of the most stable financial systems globally. **\$**

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THE BEARS SEIZE CONTROL

Revisiting the Devastating Bear Market of 1973–1974 on its 50th Anniversary

By Peter C. Earle

ON JULY 1, 1974, the economic newsletter writer James Dines wrote with a palpable sense of awe. Beginning in January 1973, the Dow Jones Industrial Average (DJIA) had fallen from 1031.68 to 806.24—almost 22%. The United States was in a recession, having emerged from another recession only a few years earlier. In his journal-like account in *The Invisible Crash* (1975), Dines comments:

You are watching history being made—movies will be made and books written about this era, such as about 1929... As bank failures and record high interest rates prompted a smashing decline below the much vaunted 800 level...we can only shake our heads at our inability to get people out of the stock market before it is too late. Who would believe Polaroid at 23½, down from an all-time high at 149, and McDonald's down 9 points in one day to 38... Add to this the bombed-out favorites of yore, like Levitz, Disney, Combustion Engineering, Damon, and Intel, where prices collapsed suddenly, affording investors no chance to get out in

time, and one realizes this is not an ordinary bear market. This is a Crash.

And the worst was yet to come. Between the publication of that missive and December 1974, five months later, the Dow would fall to 577.60. In all, 1974 saw the Dow fall just over 28% and the S&P 500 fall just under 30%. And between 1973 and 1975, those indices fell 56% and 42% of all trading days, respectively, while averaging a decline of less than one-tenth of a percent per day. Fifty years later, the period between January 1973 and December 1974 still recalls one of the most vicious bear markets in history.

Beginnings

The foundation of the deep decline in stock prices was largely laid in the preceding half decade. John Brooks, in *The Go-Go Years*, writes:

All through the stormy course of 1967 and 1968, when things had been coming apart and it had seemed that the center couldn't hold—the rising national economic crisis culminating in a day when the dollar was unredeemable in Paris, the Martin Luther

King and Robert Kennedy assassinations, the shame of the Chicago national convention, the rising tempo of student riots—the silly market had gone its merry way, heedlessly soaring upward as if everything were OK or would surely come out OK as mindlessly euphoric as a Japanese beetle in July. Or as a doomed man enjoying his last meal. One could only ask: Did Wall Street, for all its gutter shrewdness, have the slightest idea what was really going on?

The “Paper Crisis” on Wall Street between 1968 and 1970 was a major operational bottleneck caused by the sheer volume of stock trades overwhelming the manual processing systems used at the time. As the market boomed and trading activity surged, brokerage firms struggled to handle the paperwork involved in settling trades, leading to significant delays, errors and even the collapse of several firms. The crisis exposed the inadequacies of the outdated settlement system and eventually led to the development of automated processes and the creation of the Depository Trust Company (DTC) in 1973 to modernize and centralize trade clearing and settlement. This marked a turning

point in the evolution of financial markets toward greater efficiency and automation.

But before that, the paperwork debacle exposed a handful of vulnerabilities which would prove inflammatory in the upcoming slump. At the dawn of the 1970s, most Wall Street firms were still partnerships, and as such many were essentially run at arm's length. Further, many of those passively managed firms were undercapitalized. As Wyatt Wells notes in his *Certificates and Computers: The Remaking of Wall Street, 1967 to 1971*, "Whereas New York Stock Exchange volume totaled \$150 billion in 1968, those members doing business with the public had only \$4 billion in capital... As long as prosperity reigned the industry did fine, but its cushion against hard times was thin." The ensuing consolidation, which saw over 100 New York Stock Exchange member firms either liquidate or get acquired, likely contributed to the 1973–1974 bear market by weakening the market's infrastructure and reducing the ability of Wall Street broadly to absorb financial shocks.

The United States was in recession through most of 1970, and a precursor, "mini" bear market occurred in the spring

of that year. In the 59 market sessions between March 3, 1970 and May 26, 1970, the S&P 500 only had 16 positive finishes—among the lowest percentage of quarterly positive closes in the pre-1973–1974 bear market period.

The Bears Seize Control

In August 1971, the United States abandoned the Bretton Woods agreement when President Richard Nixon suspended the convertibility of the dollar into gold, effectively dismantling the post-World War II international monetary system. This decision came after years of pressure on US gold reserves, exacerbated by the collapse of the London Gold Pool in 1968, paved the way for the shift to a fiat currency system.

Stock prices rose again and then, throughout much of 1971 and 1972, traded sideways, even when in June 1972 five men were arrested for breaking into the Democratic National Committee headquarters at the Watergate complex in Washington, DC. By late 1972, US stock markets seemed to shrug off the arrival of the fiat currency dollar and the still-unfolding story of the Watergate shenanigans. But by the start

of 1973, the US Bureau of Labor Statistics Consumer Price Index (year-over-year) had risen from 2.7% in June 1972 to 3.7%. By the end of the summer of 1973, it was over 7%.

The US exit from Vietnam in 1973 contributed to uncertainty in the economy and financial markets, as war-related spending began to wind down, adding to inflationary pressures and straining fiscal resources. On top of that, a sense of malaise and disillusionment grew over the realization that the war effort, not least of which the human toll, had essentially been futile.

On October 6, 1973, Egyptian and Syrian forces launched a surprise attack on Israeli positions in the Sinai and Golan Heights, seeking to reclaim territory lost in the 1967 war. The attack, timed to coincide with Yom Kippur, caught Israeli forces off guard due to intelligence failures, allowing Egypt to breach Israeli defenses across the Suez Canal and Syria to make significant gains in the Golan Heights. Israeli forces initially struggled, particularly in the Golan, but by October 9, they shifted to a counteroffensive. With US military aid arriving on October 10, Israel regained much of the territory it lost early on. A ceasefire was announced on October 22, 1973, but not before Arab



Gas station in Oregon with "Pumps Closed" sign in October 1973, due to the gasoline shortage that occurred during the 1973–1974 bear market.

OPEC members (dubbed “OAPEC”) retaliated by imposing an oil embargo on the United States. Contributing to the spike in oil prices was the devaluation of the US dollar in the wake of the collapse of the Bretton Woods agreement two years earlier.

The impact reverberated through the US economy, with the second recession in three years starting in November 1973. Arthur Burns, chairman of the Federal Reserve, noted that the timing of the oil crisis was particularly damaging. At the time, wholesale prices for industrial commodities were already rising at over 10% annually, and industrial capacity was stretched thin. Additionally, the domestic oil industry lacked the capacity to ramp up production to meet the demand caused by the embargo, leading to severe price increases. Energy costs soared, leading the federal government to implement energy conservation measures, including speed limits and rationing programs. (The crisis led to the creation of the Strategic Petroleum Reserve and among the inaugural efforts by the government to investigate alternative energy sources to reduce reliance on foreign oil.)

From 1973 through 1974, a mix of persistent and emerging bearish factors kept surfacing, leaving little incentive to hold stocks beyond their declining prices—yet even those continued to drop. It was a macabre time for investors.

Bulls Resurgent

The first half of 1974 was grim. US Gross Domestic Product (GDP) fell by 3.4% in the first quarter, with inflation surpassing 10%. The second quarter was not much better: although GDP rose a meager 1%, inflation reached 11%. By August 1974, the average US stock had fallen 70% since 1968, but more downside was en route. Facing imminent impeachment, Nixon resigned from the presidency on August 8, 1974. The S&P 500 closed that day at 81.57 and fell to 63.39 by October 1. Around that time, a *New York Times* reporter bore witness to one of what must have been an increasingly common scene during the fall of 1974.

After the close on the New York Stock Exchange...a vice president of a Wall Street brokerage firm stopped by to check on the Dow Jones ticker that was humming with gentle, cricket-like chirps. “Good Lord!”



Trading on the floor of the New York Stock Exchange, 1973.

Images Press

he exclaimed. “The Dow is Down another 16½ points!” The blue-chip average limped in that day with a finish at 671.54, rounding out a decline of 126 points within 14 trading sessions, a period that encompassed President Ford’s ascendancy to the White House. [He] took a sip of cold coffee and grunted. “You know the trouble with this market?” he said. “The grinding away of prices. Every time you think it’s going to improve, you raise your head—and it gets handed back to you on a platter.”

On Friday, December 6, 1974, Carl Douglas’s “Kung Fu Fighting” was at the top of the music charts. *All in the Family*, *M*A*S*H* and *Kojak* were among the most watched television programs. And on that day, the US Bureau of Labor Statistics announced that the unemployment rate had reached 6.5%. The DJIA dropped to 577.60, its lowest close since the Cuban Missile Crisis 12 years earlier. And this—not that anyone would have bet at that point—was the lowest trough in the 1973–1974 bear market. The deepest and most agonizing bear market since the Great Depression had finally come to an end. Even at that point, though, things would not improve for nearly a decade; the 1973

to 1974 bear market was the nastiest part of a trough for the US economy. Between December 1969 and November 1982, the economy contracted for 49 months.

The DJIA crossed the 1,000 level for the first time just before Thanksgiving in November 1972, and then declined by essentially half over the next two years. But even after climbing off the December 1974 lows, the 1,000 level would only be decisively reclaimed in October 1982: a full decade, and two severe economic recessions, later.

At 23 months, the 1973–1974 bear market is the second longest in the post-war period (bested by the 31-month slump between March 2000 and October 2002) and the third deepest in terms of percentage decline, bested only by the Great Financial Crisis slide (a 56% drop from October 2007 to March 2009) and the aforementioned Dot Com bust/September 11 attacks period (a 49% slide). Of particular note is the nature of the 1973–1974 bear market where volatility is concerned: none of the top 20 largest one-day percent changes (up or down), largest one-day index point changes (up or down), largest intraday index point swings or largest intraday point changes with turnovers (positive to negative or vice versa) occurred within that time period. Stock prices just slowly, incessantly, melted away.



1970s trading desk at Merrill Lynch, New York City.

Aftermath

In January 1975, with the DJIA just over the 600 level and the S&P 500 creeping back toward 80, *New York Magazine* featured a cover story entitled “Wall Street Refugees: Survivors of the Crash and How They’re Making Out.” Chronicled were 10 former analysts, traders and partners of securities firms that either downsized, were acquired or liquidated beneath the grinding, nearly two-year stock decline. For most, the next act involved entrepreneurship: a bicycle shop and a steakhouse, among others. For one, a \$1,500 investment in a screenplay resulted in the seven Academy Award-winning film *The Sting*; another went back to school to pursue a medical degree. (A quick internet search of one endeavor, a delicatessen in Brooklyn, suggests strongly that five decades later the eatery endures, at least in name.)

Decades later, Wall Street veterans recall the period with exasperation and disgust. From January 2001 to September 2002, US equities were in the midst of another bear market, drifting down 27% during the period. In January 2002, Martin D. Sass of MD Sass, LLC recalled:

Believe me, having started my firm—as an equities-only special situations manager—right at the top, in March 1972, with the Dow at 1000 heading to 577 in October ’74, I really know what a bear market is like. It was gruesome, it didn’t matter how much work you did or how cheap an equity looked, it got cheaper... Try coming

in every day for 18 months, like I did from March ’72 to Oct ’74, and watching the market fall practically every day. It seemed to me that it did drop every single day; it was brutal. Even being in cash, it was horrible, and the one-third of the portfolio that was invested—because you had to have something on the table—got beaten up daily. It was tough. Even the people who are lionized now as the era’s greatest investors, people like [Warren] Buffett, were having bad problems. There just weren’t a lot of places to hide.

In May 1973, small cap trailblazer Chuck Royce took over management of Pennsylvania Mutual Fund, which lost 48.5% of its value in 1973 and 46% in 1974. In 2016, he recalled, “For me, it was like the Great Depression. Everything we owned went down. It seemed as if the world was coming to an end.”

Contrary to James Dines’s forecast, few books were written and no films produced about the early 1970s bear market, but accounts have carried forward in other ways. The economic crises of the 1970s left indelible marks on cultural landmarks, manifesting in various forms of artistic expression echoing the anxieties and uncertainties of the time. The era’s pervasive sense of economic instability gave rise to dystopian science fiction, epitomized by films like *Mad Max*, depicting a world spiraling into chaos following the exhaustion of oil in a direct reflection

of the 1973 embargo. The rise of punk rock amid stagflation (high unemployment, rising prices and falling standards of living) channeled the visceral hardships and disillusionment faced by the working class into a raw, unfiltered commentary on social problems. Moreover, the period saw a resurgence of interest in speculative fiction, with works like John Brunner’s *The Sheep Look Up* exploring malaise and environmental degradation as consequences of an allegedly unchecked capitalism. Even in architecture, stagflation contributed to the spread of Brutalism, a style characterized by stark, unadorned concrete structures that mirrored the austerity and alienation felt by many during this turbulent decade.

With “buying the dip” and bargain-hunting now deeply ingrained in the ethos of investing and trading, future declines may be shorter-lived as market participants swiftly capitalize on opportunities. Another bear market undoubtedly lurks somewhere over the horizon, but it seems likely that lessons learned over the past 50 years will lead to more tempered downturns ahead. 💰

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PRIDE IN PROSPERITY

THE ENDURING LEGACY OF JUSTIN SMITH MORRILL

since the War of 1812. Despite this legacy, the Union was able to conceive and execute a transformational revenue program that met the government's needs and provided bond investors with the confidence that interest would be paid and the principal would remain intact. Annual interest payments were as high as \$143.8 million (in 1867), twice the entire federal budget just nine years prior. All this was accomplished without any significant tax revolt. As Roger Lowenstein observes, "The federal government not only paid for the war; it had emerged from it financially stronger."

Justin Smith Morrill was the person most responsible for the Union's successful revenue program. Morrill was born in the small town of Stratford, Vermont in 1810. His formal education ended at age 13 when he left school to support his family. He worked as a store clerk until he opened his own country store in Stratford. His business acumen led to early financial independence. In 1848, he retired from commerce and began dabbling in horticulture and gentleman farming. He was elected to Congress as a Whig in 1854; in his second term, he joined the nascent Republican party. He served in the House until 1867 when the Vermont legislature elected him to the Senate. He held that office until his death in 1898. Morrill had "one of the most fruitful legislative careers" in congressional history, according to one of his 19th-century admirers.

Throughout his public life, Morrill was more pragmatic than ideological. He described himself as a champion of "frugal agriculturists" whose "cardinal virtue is thrift." In both the House and Senate, Morrill prioritized the interest of his Vermont

dramatic transformation occurred very quickly. To finance the war, the Union government followed the traditional practice of borrowing to meet military costs, while taxing to pay ordinary government expenditures and service the burgeoning debt. Much has been written about the successful bond drive initiated by Jay Cooke; less studied, but equally significant, was the revenue program initiated during the war.

Between 1863–1872, the Union—then national—government extracted \$1.739 billion in internal revenue and \$1.570 billion in customs duties from the tax-averse American populace. Prior to the Civil War, the federal government relied overwhelmingly on customs duties to meet its expenses; national internal taxes had not been levied

By Jane Flaherty

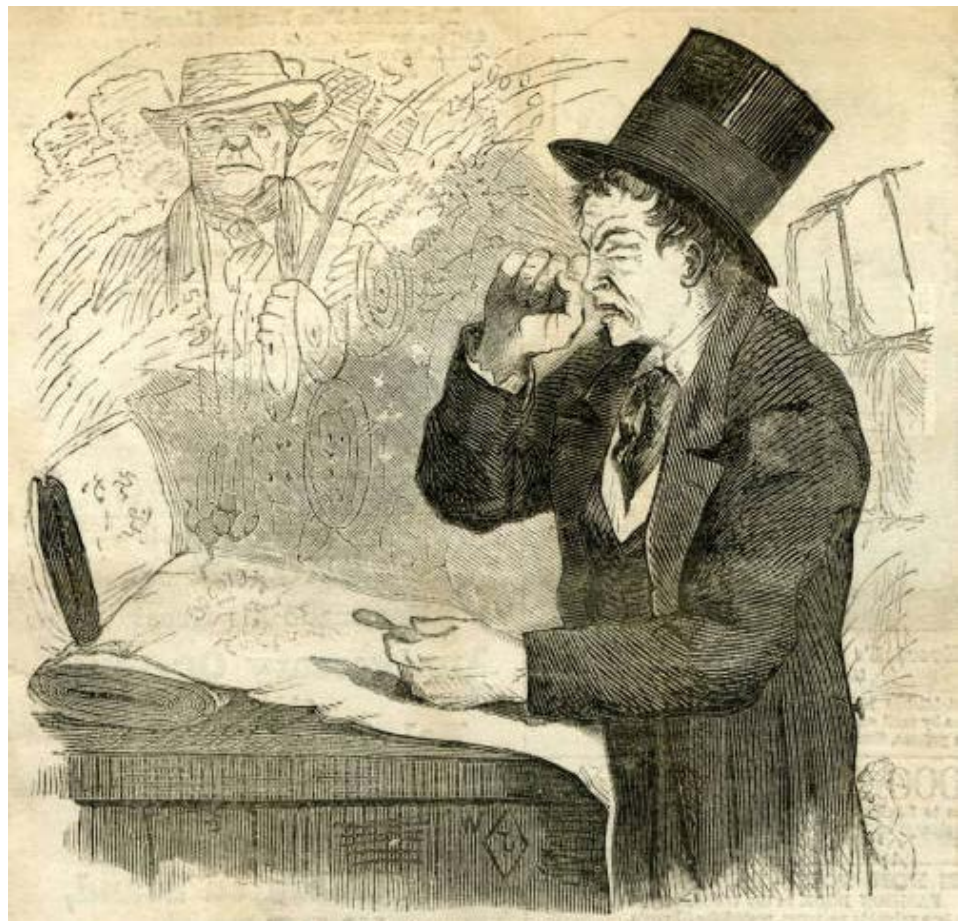
HISTORIANS DISPUTE whether the American Civil War accelerated or impeded the extraordinary economic growth that occurred in the United States during the postbellum era. What is beyond debate is that the Civil War was a turning point in the transformation of the federal government from a small, "pinchpenny" federalist institution to a postwar, national "leviathan." Antebellum federal expenditures crested at \$74.1 million in 1858; but after the war, the government's expenses never dropped below \$230 million. This

Portrait of Senator Justin Smith Morrill, circa 1855–1865.

constituents, especially sheep farmers who produced raw wool. He embodied the free labor ideology of the antebellum Republican party. According to historian Eric Foner, “In the free labor outlook, the objective of social mobility was not great wealth, but the middle-class goal of economic independence.” This remained Morrill’s perspective as he crafted fiscal policy.

Morrill is best known for the eponymous Morrill Land Grant Acts of 1862 and 1890. He regretted that his formal education ended in his teens, and strove to provide the educational opportunity he missed to the “sons of farmers to study agricultural and mechanical arts.” His land grant measures set aside federal land to create public colleges and universities and became the basis for the nation’s public university system. “Justin Smith Morrill, more than any public figure in the 19th century, changed higher education in America,” notes Peter McPherson, former president of Michigan State University. Promoting educational opportunity remained important to Morrill throughout his congressional career. As a member of the Senate Joint Committee on Public Buildings, in 1886 he wrote the bill that supported the construction of the main building that is now the Library of Congress, and he served as a regent of the Smithsonian Institution.

Morrill’s role as the primary author of both the internal revenue and tariff legislation enacted during the 37th and 38th Congresses remains his most profound, though little recognized, legacy. Before he took that role, he penned the Tariff of 1861, otherwise known as the Morrill Tariff. Approved on May 18, 1860, then tabled, this bill was enacted after southern Democratic representatives and senators departed Washington during the secession crisis. President James Buchanan signed the tariff into law on March 2, 1861, during his final days in office. This tariff measure was distinctive for two reasons. First, the schedule relied on specific, as well as *ad valorem*, duties—a departure from the previous antebellum tariffs that were predominantly based on *ad valorem* rates. Relying on specific duties in tariff schedules became the pattern for tariff legislation throughout the remainder of the 19th century. Second, it was the antebellum tariff with the shortest duration. Within a month of becoming law, the Civil War erupted and the Morrill Tariff, often mischaracterized as a war measure,



“New Tariff on Dry Goods” satirical illustration criticizing the Morrill Tariff in *Harper’s Weekly*, April 13, 1861.

was transformed to meet the fiscal needs of the Union.

The first wartime tariff revision was enacted on August 5, 1861, four months after the firing on Fort Sumter. This new bill imposed duties on coffee and tea, two items that had been on the free list (list of imports admitted duty-free), and additional duties were placed on sugar, salt and molasses. To balance the burden these import duties imposed, Morrill proposed an internal revenue bill that included the first income tax in US history. Morrill justified this measure as the “most just and equitable” tax to balance the imposition of additional costs on these “necessaries of life.”

“Ought not men with large incomes pay more in proportion to what they have than those with limited means who live by the work of their own hands,” he asked in justifying the income tax. This legislation also revived the direct tax, last imposed during the War of 1812. Direct taxes were apportioned through the states and relied on the valuation of land and personal property. The 1861 direct tax of \$20 million included all states, even those that seceded. The new

tariff schedule was implemented quickly; however, the internal revenue measures were not put into effect. The infrastructure for the collection of internal taxes did not exist. Treasury Secretary Salmon P. Chase was reluctant to impose an invasive tax program upon a population at war, and many believed the war would be a short conflict. Instead, Chase went hat-in-hand to banks in New York, pleading with them to loan funds to the government. This first session of the Civil War Congresses closed on August 6, 1861.

When Congress readjourned on December 2, 1861, a more pessimistic mood had gripped Washington. The Union army had suffered military defeats, the Treasury was empty and the requisitions were approaching \$2 million per day. Banks and financiers, who had reluctantly lent money to the government during the fall, suspended specie payments at the end of December and indicated they would no longer provide loans to the Treasury.

“The credit of the nation is ruined, the ruin of the nation, inevitable,” wrote a discouraged congressman to his wife.

Thaddeus Stevens, chair of the House Ways and Means Committee, delegated the fiscal resurrection of the Union to two subcommittees: Elbridge G. Spaulding (R-NY) chaired the Subcommittee on Banking and Currency and Morrill chaired the Subcommittee on Taxation. John Sherman (R-OH), future Secretary of the Treasury, believed Morrill was “eminently fitted” for this position because of his “practical experience” in commerce. Morrill accepted his charge and worked “night and day” on the different revenue bills.

Few studies of Civil War financing look at the tariff and internal revenue laws as integrated, but that is how Morrill saw them. “The weight must be distributed equally not upon each man an equal amount, but a tax proportionate to his ability to pay,” was how he described his effort to distribute the tax burden during the war. Morrill wrote two comprehensive internal revenue laws: HR 312 (1862) and HR 405 (1864). The text of HR 312 filled 17 pages in the *Statutes at Large*, at that time, the longest bill passed by Congress. The majority of the revenue produced by these two bills came from three sources: a three, then five, percent tax on manufactured goods; an income tax on salaries above \$600; and sumptuary excise taxes on alcohol and tobacco. The combined revenue measures were designed to spare agricultural production. Morrill described agriculture, not manufacturing, as “the most important field where we are to meet the world as rivals.” He noted in 1865 that, “We have in all cases endeavored to avoid taxation upon the products of the farm. It is only upon manufacturers that we have endeavored to levy a tax.”

To meet the war expenses, tariffs were modified 11 times between 1861 and 1867. Two comprehensive tariff bills were passed, in 1862 and 1864, in conjunction with the internal revenue measures. The Tariff Act of July 14, 1862 enacted “compensating duties” levied on all imported commodities competing with home manufacturers who were paying a 3% *ad valorem* tax on all goods they produced. “It will be indispensable for us to revise the tariff on foreign imports so far as it may be seriously disturbed by any internal duties... If we bleed manufacturers, we must see to it that the proper tonic is administered at the same time.” The Tariff of 1864 embedded this principle: “This need for compensation, for the demands



Early Civil War Treasury note authorized by the Morrill Tariff Act of 1861.

of government for more revenue...offered protectionists who controlled Congress unexampled opportunity.”

Like his internal revenue bills, the tariff legislation Morrill drafted was extraordinarily detailed. “Seeking to avoid all extremes the committee have thought best to propose duties upon a large number of objects, rather than confine them to a narrow field.” The Morrill Tariff had approximately 310 dutiable items listed; by 1872, the number of dutiable items rose to over 930. As each tariff revision was enacted, members of Congress sought to apply protective duties to specific items produced in their congressional districts.

“This need for compensation, for the demands of government for more revenue...offered protectionists who controlled Congress unexampled opportunity,” notes tariff historian F.W. Taussig. After the war, “Whatever a politician’s ideological stance, it was essential to defend producers in one’s home district,” writes Nicholas Barreyre. Both Republicans and Democrats acquiesced to the protection embedded in the war tariffs. The tariff rates increased dramatically during the war, reaching a high of 48.6% in 1868. These high rates remained in place, with only “minor changes” until 1883.

When Morrill’s fiscal legacy is considered by historians, he is labeled a “protectionist,” a pejorative used to paint the individual as corrupt and in the thrall of “greedy manufacturers.” Although a consistent and steadfast opponent of free trade, Morrill believed in what he called “fair trade: an exchange of products costing an equal amount of labor,” as well as “incidental protection,” meaning targeted

protection for select commodities. For Morrill, this meant raw wool produced in Vermont. The protectionist label has stigmatized Morrill, although over the course of a decade, from 1861 to speeches he delivered later in the Senate in 1874, he groused that, “I believe that the duties on most articles are put too high...the duty on iron is too high. I would have been glad if all the interests of the country could have been harmonized, to have fixed it [the overall tariff rate] somewhat less.” James Garfield remarked once to Morrill, “I thought you were an extreme protectionist, but I find that in the hearings before the committee, you are fighting against too much protection continually.”

Morrill’s goals in both tax and tariff legislation were to promote domestically produced agricultural products and raw materials and avoid “the social miseries of England—vast numbers of poor, overwhelming monopolies, a disgraceful distribution of wealth and an oppressed working class.” Morrill consistently stated that the tax program he created would benefit the agriculture sector more than manufacturing, and provide a better standard of living for workers. In an 1870 speech delivered in the Senate, Morrill stated with satisfaction that, “Our country is the one toward which the eyes of the world are turned. It is the magnet which attracts emigration from all Europe and part of Asia...men and women believe that they can here earn much more than...they now receive [in Europe]. They know...our country is the one before all others where the poor can get rich.”

When Morrill moved to the Senate, he became a “calm onlooker” regarding tariffs



Senator Justin Smith Morrill's house in Strafford, Vermont.

and tax policy; however, as a member of the Senate Finance Committee, he played a key role in the vexing conflict over the “money question.” During the war, three Legal Tender Acts were passed, authorizing the Treasury to issue fiat currency, commonly known as greenbacks. After the war, a battle erupted between “hard money” supporters, who wanted to curtail the circulation of greenbacks and force a speedy return to specie payments, and “soft money” proponents, who strongly opposed the contraction of greenbacks.

Morrill supported contraction and a return to hard money policies. He noted in 1866 that \$944 million in currency circulated, including bank notes, legal tender and compound-interest notes, and he urged the country to return to “sound finance.” He helped draft the legislation that gave the Treasury the authority to contract the currency in circulation. Two of Morrill’s closest colleagues in Congress, Thaddeus Stevens and John Sherman, were “soft money” advocates. Stevens died in 1868, but the differences between Sherman and Morrill intensified and led to a rift that chilled their relationship.

Morrill’s popularity in Vermont created a sinecure for him. During his final years in the Senate, he was seen as a “counselor rather than a leader.” When Congress was divided, with Republicans controlling the House and Democrats the Senate, Morrill contented himself with amassing a personal library, designing a stately home in Washington and publishing a collection of essays, titled “Self-Consciousness of Noted Persons.” His non-partisan pragmatism faded, and he became more entrenched in the postwar Republican beliefs in protectionism and “hard money.” Morrill continued to take pride in the prosperity of the nation, even as the financial position of the farmers and laborers he championed during the war became more precarious. **\$**

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100 Years of Mutual Funds

Mutual Funds Capitalize on Opportunities Created by Tax and Banking Laws

By Matthew P. Fink

THIS YEAR MARKS the centennial anniversary of the first mutual fund, Massachusetts Investors Trust. With mutual fund assets now totaling over \$27 trillion and more than 116 million Americans owning mutual fund shares, it is currently the nation's largest financial industry. As Senator Ed Markey noted, mutual funds are "a genuine American success story."

Frequently cited factors for the success of these funds include public confidence engendered by investor protections in the Investment Company Act, as well

as the development of new mutual fund products and services to meet changing investor needs. But there is also a less-recognized factor—funds taking advantage of opportunities created by tax and banking laws, including the Revenue Act of 1936, Section 11 of the Glass-Steagall Act of 1933 and the Revenue Act of 1978.

Creating the Mutual Fund "Brand": The Revenue Act of 1936

Companies that issue their shares to the public and use the proceeds to acquire portfolios of securities became popular in the United States in the early 1920s.

All of these companies were "closed-end funds," funds that issue shares on a

one-time basis, with the shares then trading at premiums or discounts from the value of their portfolios. At the height of the 1929 bull market the average closed-end fund was trading at a premium of 47%. Many closed-end funds employed leverage by issuing bonds and preferred stock. In a rising stock market leverage increases fund performance, and in a falling market leverage hurts performance. Many closed-end firms were managed by securities firms; observers warned that these firms could dump questionable securities into their funds.

In the mid-1920s a new type of investment company, known as an "open-end fund" or mutual fund, was introduced in Boston. The first three mutual funds

Massachusetts Investors Trust certificate of interest, issued to trustee L. Sherman Adams, July 1924.

were Massachusetts Investors Trust, State Street Investment Corporation and Incorporated Investors. These mutual funds differed from closed-end funds in three important ways:

1. The funds were required to buy back (redeem) their shares upon a shareholder's request at a price based on the current value of the fund's portfolio. Therefore, fund shares did not trade at premiums or discounts.
2. The funds issued only common stock. Thus, the funds did not employ leverage through the issuance of senior securities.
3. The funds were managed by small groups of individuals, not securities firms. Thus, the funds did not raise the problem of dumping.

The leaders of the three Boston mutual funds wanted the public to distinguish between their conservative mutual funds and risky closed-end funds.

The 1929 stock market crash reinforced their belief that mutual funds were superior. The three mutual funds went down with the market, 70–80%. Closed-end funds did far worse due to reverse leverage and shares moving to deep discounts. American International fell from 84 to 6; Goldman Sachs Trading Corp. from 110 to 2.5; and US and foreign securities from 64.5 to 1.875.

By happenstance, a proposed income tax law gave the heads of the three Boston funds a way to help the public distinguish mutual funds from closed-end funds.

Historically, federal income tax law provided a 100% exclusion for dividends received by one corporation from another corporation. Therefore, investment companies did not pay tax on dividends they received from portfolio companies.

In 1935, Congress reduced the inter-corporate exclusion to 90%. Investment companies now had to pay tax on 10% of the dividends they received. Thus, fund shareholders received lower returns on their funds than if they owned securities directly. Investment companies feared this would cause investors to reject investing in funds.

In March 1936, President Franklin D. Roosevelt proposed a new tax scheme under which a corporation would receive a 100% deduction for dividends it paid to its shareholders. Leaders of the first three mutual funds saw this as a “godsend” that could both solve their tax problem and help the public distinguish mutual funds from closed-end funds.

They proposed to the administration a provision under which an investment company with redeemable securities (that is, a mutual fund) which distributed all of its income to shareholders would be

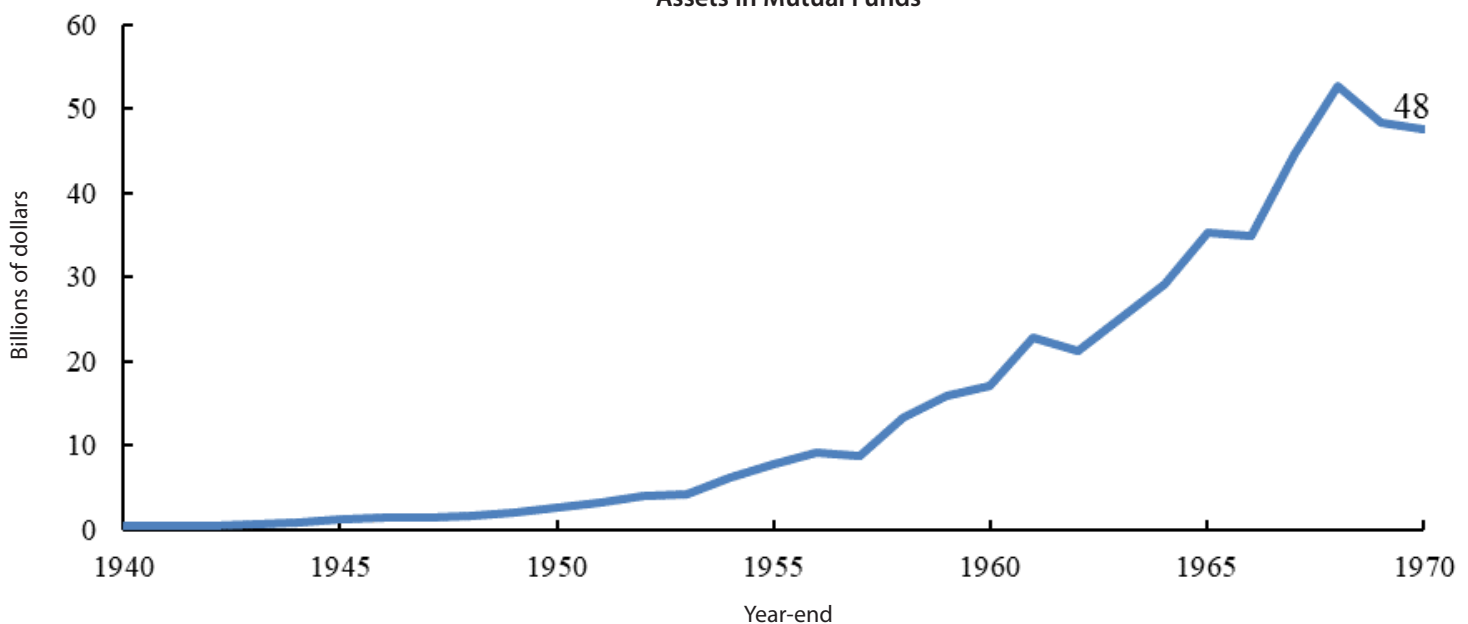
ignored for tax purposes. Administration officials proposed conditions that the three mutual fund leaders readily accepted, since they mirrored their funds' existing practices. One condition required that the fund's portfolio be diversified. Another was designed to prevent fund control of other companies. A third limited short-term trading.

The final Revenue Act of 1936 granted mutual funds that met these conditions, but not closed-end funds, a full exemption from taxation. Thus, mutual leaders had taken a major first step toward distinguishing mutual funds from closed-end funds and creating a distinct mutual brand.

Mutual fund leaders realized that the Revenue Act of 1936 did not incorporate two other key characteristics of the first three mutual funds—the absence of fund use of leverage through issuance of senior securities and fund sponsors not being able to sell securities to their funds. Four years later, mutual funds supported enactment of the Investment Company Act of 1940 precisely because it required *all* mutual funds to have these two characteristics.

After enactment of the Investment Company Act, the mutual fund brand was complete—every mutual fund was required by law to provide daily redeemability of its shares, not issue senior securities, not purchase securities from its

Assets in Mutual Funds



Note: Data for funds that invest primarily in other mutual funds were excluded from the series

Source: Investment Company Institute

sponsor, have a diversified portfolio and avoid control of portfolio companies and short-term trading.

The first step in the development of this strong mutual fund brand was the decision by fund leaders to seek provisions in a tax law, the Revenue Act of 1936.

Revolutionizing the Mutual Fund Industry: Section 11 of the Glass-Steagall Act of 1933

Mutual funds enjoyed steady growth following enactment of the Investment Company Act. In 1944, for the first time, mutual fund assets exceeded those of closed-end funds, a situation that has prevailed ever since. Total mutual fund assets went from \$450 million in 1940 to \$48 billion in 1970. The vast majority of funds invested in stocks, with some bond funds and balanced stock and bond funds.

Most Americans did not invest in mutual funds or in other securities. Instead, they placed their savings in savings accounts offered by banks and savings and loan associations. Congress had been concerned that if banks could set the interest rates on their deposits they would engage in risky activities in an attempt to pay higher rates. Therefore, Section 11 of the Glass-Steagall Act of 1933 mandated that the Federal Reserve Board impose

interest rate ceilings on bank savings accounts. In 1966, Federal Reserve Board Regulation Q was extended to accounts at savings and loan associations. In 1970, certificates of deposit of \$100,000 or more were exempted from Regulation Q.

The system worked fairly well until the late 1960s ushered in extremely high inflation. Americans had to pay 10% or more on their borrowings, but due to interest rate ceilings, most Americans earned less than 5% on their savings. Institutional investors and wealthy individuals could earn market rates of interest by purchasing large bank certificates of deposit or Treasury bills of \$10,000 or more. But most Americans were stuck.

In 1972, individuals in New York and California came up with the same idea—create a mutual fund that would invest in large certificates of deposit and Treasury bills, earn high interest on these instruments and pay out that interest less expenses to fund shareholders. There were favorable stories about these funds in the media, and money began flowing to them.

Seeing the success of these first two “money market funds,” traditional mutual fund firms brought out their own money market funds. Money market fund assets increased at a rapid pace, growing from less than \$2 billion in 1974, to \$76 billion in 1980, to \$1 trillion in 1997, to over \$6 trillion today.

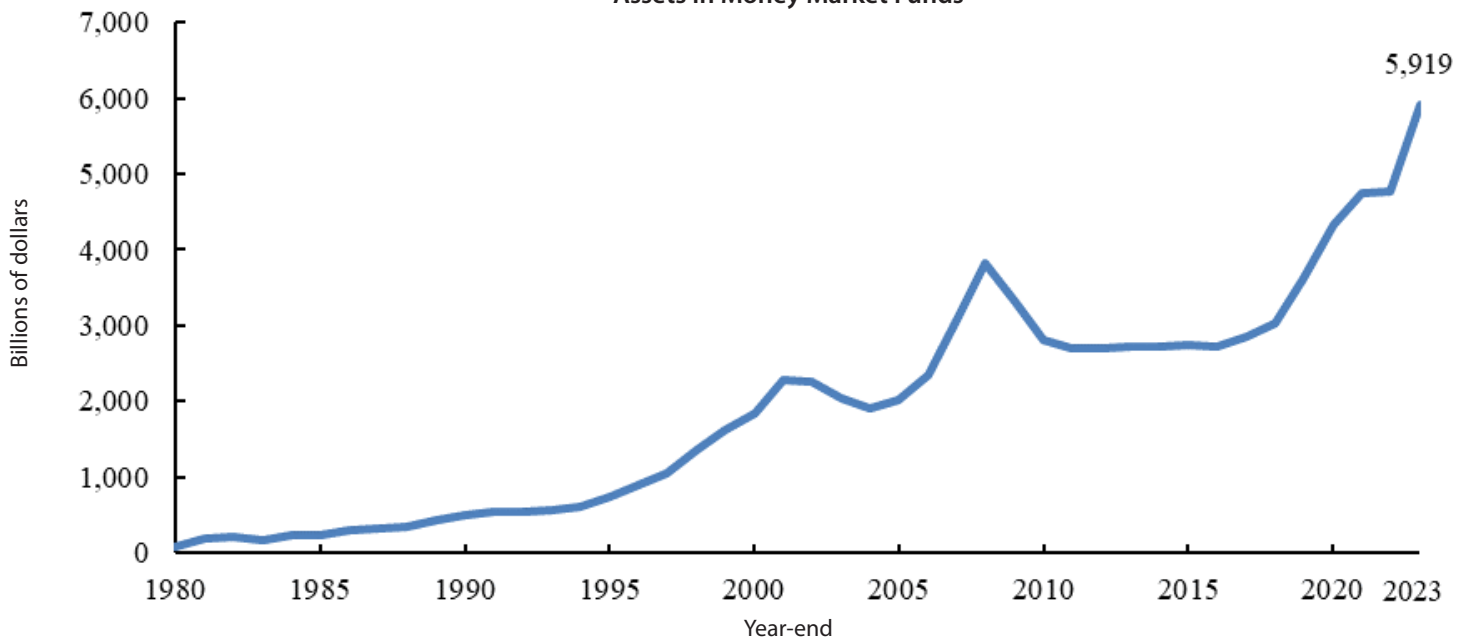
Money market funds expanded the size and diversity of the mutual fund industry. Millions of Americans who had never invested in mutual funds or other securities put money into money market funds. Many of them went on to invest in stock and bond funds. Today, mutual fund assets are spread among stock funds (54%), money market funds (22%), bond funds (18%) and balanced funds (6%).

Money market funds revolutionized the fund industry. This was made possible because mutual fund firms took advantage of interest rate ceilings established pursuant to a banking law, the Glass-Steagall Act.

Revolutionizing the Private Retirement System: The Revenue Act of 1978

For decades after World War II, the retirement system was dominated by defined benefit (DB) plans—plans under which employers promise employees fixed benefits after they retire. Defined contribution (DC) plans—plans under which employers contribute fixed amounts to employees’ retirement accounts—were far less common. In 1979, more than 80% of individuals who participated in private plans were in DB plans. In that year, assets of DB plans were roughly two-and-a-half times the size of the assets of DC plans. Many DB plans were managed by banks and insurance companies; DB plans rarely invested

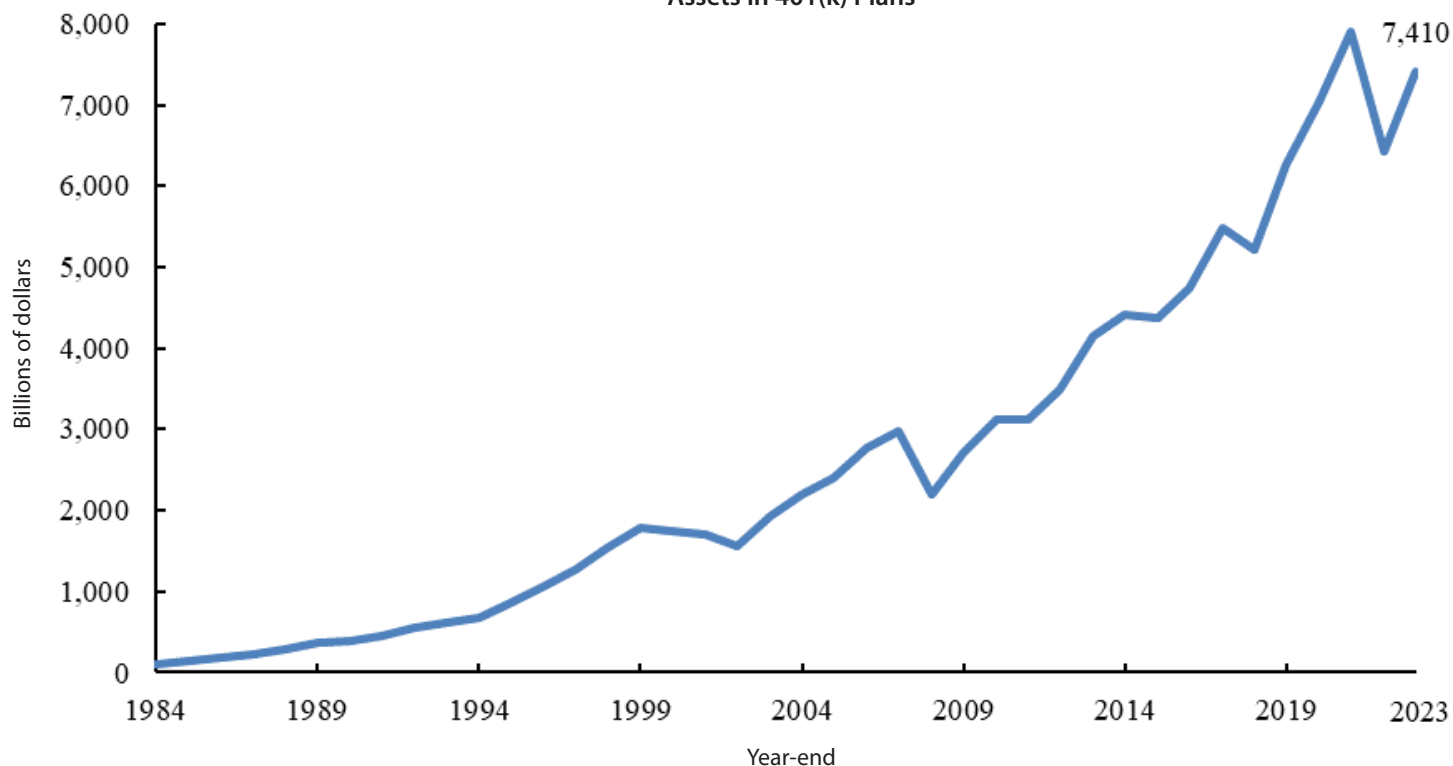
Assets in Money Market Funds



Note: Data for funds that invest primarily in other mutual funds were excluded from the series

Source: Investment Company Institute

Assets in 401(k) Plans



Sources: Investment Company Institute and Department of Labor

in mutual funds. Mutual funds held only a tiny share of the DC plan market.

In recent decades, there has been a massive decline in DB plans. Many employers terminated their DB plans and almost no new DB plans have been created. By 2015, only 3% of Fortune 500 companies offered traditional DB plans to their newly hired employees. The main factor behind the huge decline in DB plans is the 1974 pension reform law, the Employee Retirement Income Security Act (ERISA), which imposed huge costs on employers with DB plans.

Just as employers began terminating their DB plans, the mutual fund industry used a tax law to create an entirely new type of retirement plan—the 401(k) plan.

The process started when employers began offering cash or deferred profit-sharing arrangements, programs under which an employee could take a bonus in cash or have it invested in a plan. In 1972, the Internal Revenue Service proposed regulations that raised the issue of “constructive receipt” treatment—even though an employee elected to have her bonus go into the plan she should pay tax on the bonus because she had the right to take the bonus in cash. Policymakers wanted time to study this issue, so in 1974,

Congress delayed the implementation of the regulations for cash or deferred plans already in existence.

The Revenue Act of 1978 added Section 401(k) to the Internal Revenue Code, providing that if rank-and-file employees participate in a plan, a payment by the employer that the employee elects to defer would not be included in the employee’s income. Congressional committee reports indicate that Congress enacted the provision because it was dissatisfied with the 1978 moratorium that discriminated against employers who had not yet adopted cash or deferred plans. Congress had no idea that it was laying the groundwork for an entirely new type of retirement plan—the 401(k) plan.

In 1979, Ted Benna, a retirement benefits consultant, created the first 401(k) plan. He solved the issue of required participation by rank-and-file employees by providing that the employer would partly match employees’ own contributions. The mutual fund industry saw the opportunities created by the Revenue Act of 1978 and began offering 401(k) plans to companies across the nation.

Since then, 401(k) plans have skyrocketed. Assets of 401(k) plans increased from

\$144 billion in 1985 to over \$7 trillion today. During this same period, the number of participants in these plans grew from 10 million to 70 million. Mutual funds are a near-perfect fit for 401(k) plans, since fund organizations offer a wide range of funds, provide participants with detailed information about each fund and permit participants to easily switch among funds. Today, mutual funds account for 65% of total 401(k) plan assets.

The revolution in the retirement system—the massive movement from DB plans to 401(k) plans—was due to a combination of ERISA’s devastating impact on companies with DB plans and the mutual fund industry’s ability to take advantage of a technical tax law, the Revenue Act of 1978. **\$**

Matthew P. Fink is the author of The Rise of Mutual Funds: An Insider’s View (Oxford University Press, second edition 2011) and The Unlikely Reformer: Carter Glass and Financial Regulation (George Mason University Press, 2019). He is a past president of the Investment Company Institute, the national association of US investment companies.

RACING TO PROSPERITY



How a Mid-Century Road Race was an Economic Engine for One Wisconsin Town

By Holly Beretto

IT SEEMED OUTLANDISH AT THE TIME. But Elkhart Lake, Wisconsin was in a bit of a slump. While the 1950s may have been an economic boom in the rest of the country, this secluded spot outside Sheboygan, known for its lakeside resorts, wasn't part of it. Factories may have turned Milwaukee and Green Bay into industrial powerhouses, but little Elkhart Lake had no such thing. In fact, a canning factory had shut down in 1949.

Jim Kimberly with his crew, circa 1950s. Kimberly was instrumental in bringing road races to Elkhart Lake, turning the tiny village hamlet into a racing powerhouse that endures decades later.

What Elkhart Lake did have, however, was the lake. The village had been a vacation spot ever since the railroad added a stop there in 1873. People from Milwaukee (only about an hour south) and Green Bay (a bit further north) and even from Chicago came to enjoy the village's bucolic setting. The lake, one of the deepest in the state, offered all manner of boating and watersports. It was a place where city dwellers came to escape summer heat, and Elkhart Lake was proud of its tourism trade, which generated income for hotels, shops and restaurants.

But while fewer tourists had come during and just after the war, Elkhart Lake's resort identity was about to turn this little place into one of the biggest spots on the map for car enthusiasts.

"You had a lot of young men go off to

war in World War II," said John Ewert, communications director for Road America. When those young men returned home from the European theater, they brought back a whole host of wartime souvenirs, including one that changed the face of sports in America.

"Many of them literally imported their own cars, such as MGs, Jaguars, all sorts of other British sports cars, like Austin Healey and Morgans," continued Ewert. "They brought them here to the United States because they could buy them cheaper overseas than they could here."

And then, they started racing them. Throughout the late 1940s, places all over the country saw a rise in road racing. From Watkins Glen in upstate New York, to Lime Rock in Connecticut, to Sebring in southern Florida and all the way out to



The starting and finish line for a race through Elkhart Lake, Wisconsin.

Pebble Beach in California, car enthusiasts combined their love of chrome and steel with the need for speed.

All of this was organized by the Sports Car Club of America (SCCA), originally formed in 1944. As road racing gained popularity, the SCCA divided the country up into regions; the Milwaukee region began in 1947 and Chicago followed in 1949.

That's how Jim Kimberly, who grew up in Neenah, Wisconsin and was living in Chicago, and who was heir to the Kimberly-Clark Corp, entered the picture. A member of the Windy City' SCCA region, he felt the roads around Elkhart Lake were perfect for a road race.

First, he convinced SCCA regional directors to check out the homey hamlet, and they shared his enthusiasm. He then brought together several Elkhart Lake leaders to gauge their interest in hosting such a thing. Jim Johnson of Elkhart Lake Bank; Ray Kramer, the village fire chief; Everett Nametz, who owned a local hardware



A statue of Jim Kimberly was dedicated in 2000, commemorating his passion for racing and his vision for bringing road races to Elkhart Lake.

store; Paul Just and Floyd Dixon of the Osthoff Hotel, which is now the Osthoff Resort; Olive (Ollie) Siebkens Moeller of Siebkens Resort; Ed Levernz from Quit Qui Oc Golf Course; dentist William Loos; and highway engineer Clif Tufte, all part of the 1950 race committee, felt this was a fine idea. They set about making plans.

The race was set for Sunday, July 23, on a 3.3-mile course just north of Elkhart Lake. Drivers from the nearby regions came to compete.

Shortly after the *Sheboygan Press* published a story in its June 19, 1950 edition about the upcoming race, the enormity of it was felt throughout the little village. According to *The History of the Elkhart Lake Road Races, 1950–1952: 60th Anniversary Edition*, published by the Elkhart Lake Historic Race Circuits Preservation Society, a letter went out to residents inviting them to a meeting about the proposed race and asking them to volunteer to make the race a success. Every volunteer spot was filled



Wisconsin Historical Society, WHI-142942

Spectators watch a race car on the road around Elkhart Lake, Wisconsin, circa the 1950s. European-style road races helped cement the village's reputation as a spot for serious racers.

following that meeting on July 21, 1950.

Every hotel room filled up, too. Ollie Siebkens Moeller coordinated the advertising efforts. Hotel rates for race weekend in 1950 were \$10 per day (about \$130 in today's dollars) per person, with double occupancy and without a private bath. Rooms with their own or a connecting bathroom would run \$11 per person per day. Three meals a day were included. Tourist rates started at \$2 per day, and a two-day minimum was required.

The event was a smash, drawing anywhere between 1,500 and 5,000 spectators. (No official records were kept.) Crowds lined the streets, sat on hay bales, climbed on roofs and otherwise packed the roads to see the cars race by.

There were four races over that first weekend: two novice races, one for cars under 1500 cc, one for cars over 1500 cc, a ladies race and the Main Event, for experienced drivers. Kimberly, cut very much

of the gentleman racing car driver mold, competed in the Main Event, a 67-mile, 20-lap affair.

"Jim Kimberly brought a 1948 Ferrari 166MM," said Christian Øverland, the Ruth and Hartley Barker Director and CEO of the Wisconsin Historical Society. "And he wins his race! And racing at Elkhart Race becomes a reality that attracts racers and their cars from Wisconsin, Chicago and then the whole nation."

"It was basically the savior for this village because it's been about cars ever since," Spencer Chapple, the Elkhart Lake Historic Race Circuit Preservation Society secretary, treasurer and informal historian, told the *Sheboygan Press* in an August 25, 2016 story.

While the attendance numbers might not seem like a lot, what that 1950 race did was shine a spotlight on Elkhart Lake.

"The Milwaukee paper is writing about auto elites coming to Wisconsin, to race at

this great course called Elkhart Lake," said Øverland. "Because the race is European style, it's attractive to these people buying European sports cars. Those drivers are becoming very good at this point, and becoming professionals."

Those professional drivers took notice of what was happening in Elkhart Lake. By 1951, the road race's second year, the course was doubled to 6.7 miles, making a full loop around Elkhart Lake. The SCCA designated all of the races as "National Points" races, which virtually guaranteed drivers from around the country would converge on the village, upping the cache of the races from regional attractions to national events. Elkhart Lake's race committee would promote it as an international event, due to the number of European cars that would be included.

The race was set for Sunday, August 26, 1951. More than 20,000 people were expected. *The History of the Elkhart Lake*

Road Races, 1950–1952: 60th Anniversary Edition lays the blame for that at the feet of the *Milwaukee Journal*. “In March [1951], the *Milwaukee Journal*, probably influenced by the designation as ‘International,’ raised the estimated attendance figures from the 1950 event to between 15,000 and 20,000 spectators. While it was an exaggeration, it did indicate what

Elkhart Lake could expect in spectator attendance.”

Drivers came from 24 states; 50,000 spectators lined the streets. Once more, a tiny hamlet in Wisconsin swelled with car enthusiasts.

By 1952, the Elkhart Lake Road Races expanded to two days, September 6 and 7, and the *Sheboygan Press* crowed, “Elkhart

Lake is becoming a road racing center and rival of Le Mans, France.” The village’s 700 hotel rooms were set, once again, to be filled to capacity, and newspaper headlines blared that more than 120,000 were expected to converge on the village.

“They got close to 150,000 spectators [in 1952],” said Overland. “But there is an issue that happens with the race. They’re



Road America founder Clif Tufte with Dan Gurney.

racing 120 miles an hour in public streets, it's becoming very dangerous. And eventually the State of Wisconsin creates a law stopping public street racing and the need for a closed course track emerges to keep this new auto racing tourism growing at Elkhart Lake."

As enthusiastic as the drivers and spectators were, there was no doubt that road racing like this was problematic. Just about two weeks after Elkhart Lake's third road race, where eight people were injured after the MG driven by William Taylor plowed through snow fencing on Lake Street at the course's "Hard Left" turn, an even more devastating accident happened up in Watkins Glen, New York.

Seven-year-old Frankie Fazzary was killed when an Allard J2 driven by Fred Wacker, who'd also competed in Elkhart Lake races and helped his friend Jim Kimberly put them on the map, clipped a curb along Franklin Street and slammed into the crowd watching the race. Fazzary was the only fatality, but 12 spectators were injured. The incident shocked the country, and laws quickly followed outlawing road races on city streets, including, as Overland said, in Wisconsin.

By that time, racing had become part of the community pride that ran through Elkhart Lake. The village loved that it was central on the racing circuit, with drivers from across the country coming to town. There was no doubt that road racing couldn't continue the way it had for the last three years, but allowing it to disappear entirely was out of the question.

This time, it was Clif Tufte who had the brainstorm. He owned a majority share in the Elkhart Sand and Gravel Company. Tufte, a World War I veteran who had worked with the Army Corps of Engineers, had been with the sand and gravel firm since 1929, slowly purchasing shares in the ensuing decades. By the 1950s, the gravel business was in decline, but the land it sat on would prove a godsend to the Elkhart Lake race committee. Tufte was willing to sell the land to create a road racing center, but a small parcel of property abutting the sand and gravel pits would also need to be purchased.

"He got together these people [on the race committee] and he said, let's sell shares and everybody can get a share," said Ewert.

One of the most instrumental people to the stock-selling plan would be Ollie Siebkens. For three years, she'd been the



Wisconsin Historical Society, WHI-60842

Spectators near the grandstand of Road America. Racing through the streets of Elkhart Lake led to the creation of Road America, a permanent course that today hosts more than 400 events every year. It's been in continuous operation since 1955.

only woman on the Elkhart Lake race committee, and she'd even driven in one of the races. Her dedication to the village and boosterism of road racing made her a natural when it came to encouraging others to buy shares for the new racing space.

She enlisted the help of Kay Dixon, the daughter of Paulina Osthoff Just, whose family owned the Osthoff Resort, just a few steps away from Siebkens, and who, along with her brother and husband, ran the place. Together with Gertrude Laun, who was active in several Elkhart Lake and Wisconsin civic groups, they worked to sell shares for \$100 each.

Cost projections for the project were \$175,000, and the plan was to sell 1,750 shares. Before the stock could be issued, however, there needed to be a commitment of \$75,000, a goal reached in April 1955, even though construction started in 1954.¹

"They bought 525 acres of farmland," said Ewert. "In some areas of the property, you can see a barn and silos that were on the dairy pastures."

In building what would become Road America, Tufte dropped a stake in the ground where he planned to build the course. Then, he walked the whole of the track, dropping more stakes in where he wanted turns to be.

"They didn't bring in a bunch of bulldozers or flatten everything out," said Ewert. "He just walked the land and he said, 'You know, I want something that's going to be pretty similar to the road courses going around the lake. I want a lot of rights and a lot of lefts, some long straightaways, because that's what people are used to.'"

With the old road race course as their guide, Road America grew from the gravel and sand pits abutting acres and acres of dairy farms seven miles south of Elkhart Lake. The 32-foot-wide track, with 14 turns across four miles, opened on September 10, 1955. Phil Hill, driving a Ferrari Monza, won by a hair over Sherwood Johnston, driving a D Jaguar.

Today, it's one of the premier closed circuit road race courses in the world, still drawing visitors to Elkhart Lake. Novices and professional drivers alike come to run the course, which hosts IndyCar Series, the IMSA Sports Car Championship, WeatherTech Chicago Region SCCA June Sprints and a host of open track days. On race weekends, the village's population, currently 959, swells to more than 100,000.

A 2022 study by the Washington Economics Group, commissioned by Road



The historic marker outside Siebkens Resort indicates the spot of the hard left turn on the original road race course.



The Hard Left Lounge at Siebkens Resort pays tribute to Elkhart Lake's racing heritage. The resort is typically sold out on racing weekends.

America, estimated the track brings in \$254 million a year in economic impact for Sheboygan County. Of this, \$181 million (71%) is due to direct economic effects, with \$73 million attributable to indirect and induced economic effects. In addition, this economic activity supports 2,975 jobs, generates \$83 million in household income, \$131 million in Gross Domestic Product (GDP) and \$34 million in federal, state and local fiscal revenues throughout the county. The estimated economic impact on the state of Wisconsin is \$403 million.

"I would say that probably at least 60% of our business, both lodging and food and beverage, is somehow tied to Road America," said Wendy Orth, who owns Siebkens Resort along with her husband.

Originally from Appleton, Wisconsin, about 45 minutes northwest of Elkhart Lake, Orth grew up going to races at Road America, where her father was an amateur racer. Several of her friends and her sister worked in the racing industry while in their 20s. She loves being part of the village's ongoing tradition of road racing.

"You hear the stories of how college students grew up waiting tables here and basically paid for their education at the University of Wisconsin by waiting tables for one summer," elaborated Ewert. "That's kind of cool."

Given the economic impact to the village, it might not be surprising that the

residents and business owners are fully supportive of the road races in the area. Ewert, though, sees something different, something more personal.

"It's neat to see how the village has really embraced us," he said. "They're not angered by us. They don't complain about the noise. They love the amount of visitors. Residents volunteer at the track, and we employ many of them every season. I've had people tell me, 'I just love working the gates 'cause I love meeting everybody. And once we get done, I can go watch some racing or hang out with my friends.' They understand the importance of this place."

That importance isn't only for Road America, which celebrates its 70th anniversary in 2025. It's also for Elkhart Lake, and the dream it represents—a dream that came true. It was a wild idea to bring a road race to this tiny lakeside resort. More than 70 years later, those races live on, a tribute to Elkhart Lake's past and a road to its future. The original race route is on the National Register of Historic Places, and signs dot the roads around the village, with drivers of all stripes still cruising them today. The Siebkens Resort sits at the route's "Hard Left" marker and is on the Register as well.

"[Through the years] you have all these famous racers who've come through," she said. "Patrick Dempsey has been seen here and there in Elkhart Lake. Back in the

day, [racing] would bring Paul Newman to Elkhart Lake. People just want to come and visit a place where these other people have been." 💰

Holly Beretto is a freelance writer based in Houston, where she covers the arts, education, history and interesting personalities. A marketing and communications professional with 30 years of experience, her work has appeared in 365ThingsinHouston.com, CultureMap.com, Houston Family magazine, Houstonia magazine, Santa Clara Magazine, the Texas Catholic Herald, the Where Guest Book and others. She previously co-wrote a story on the centennial of the Houston Ship Channel for Financial History with Gregory DL Morris.

Note

1. Many of those original stock issues are still owned by the original families, so Road America is privately owned and publicly traded, with employees reporting to the board of directors and the board reporting to the shareholders. If and when shares do become available, they're snapped up by other shareholders fairly quickly. Road America wouldn't give a share value, but did note that an original share purchased for \$100 in 1954 would be worth many thousands of dollars today.



RETURN OF THE SILVER DOLLAR

Free Silver and the Bland-Allison Act

By Eric Brothers

THE COINAGE ACT OF 1873—which put an end to the silver dollar as a monetary standard—was not without controversy. Bimetallists claimed Congress passed the act due to the unscrupulous influence of a coterie of government bondholders who schemed with Treasury officials and high-ranking congressmen.

This cabal, through creating a single gold unit of account, presumably hoped to raise the market value of its public securities. Free Silver¹ supporters called this conspiracy theory surrounding silver demonetization the “Crime of 1873,” although from 1873 to 1876, few Americans complained about demonetization of silver or asserted

that a heinous “crime” had taken place. The eventual remedy for this alleged “crime” was the Bland-Allison Act of 1878.

Production and Price of Silver

Silver production in the western mines soared during the 1870s, reaching 17,789,000 ounces in 1871, surging to 27,650,000 ounces in 1873 and rising even further to 29,996,200 ounces by 1876. A significant amount of this silver was extracted from the Comstock Lode in Nevada. As production ramped up, the price of silver began to fall. Allen Weinstein, author of *Prelude to Populism: Origins of the Silver Issue, 1867–1878*, attributes the decline in the price to “silver’s demonetization by both Germany and the United States during the early 1870s.”

However, that analysis appears to be suspect, as it was causal. The falling price of silver was due to its overproduction, which led Germany (1871) and the United States (1873) to demonetize it. Other nations also demonetized silver or halted

coinage of silver during the early 1870s. The bullion value of the 412.5 grain US silver dollar was around one dollar in 1873 and fell to less than 90 cents in 1876, the year the movement for silver remonetization began.

The Free Silver Movement (1876–1878)

The battle for the return to bimetallism and free silver was first waged in the midst of the lowest point of the Long Depression (1873–1877) after the Panic of 1873, when a highly speculative period following the Civil War resulted in an inevitable collapse of credit and prices. The year 1876 saw every aspect of commerce and production hit a new low. Thus, it was no coincidence that the Free Silver movement was sparked during that watershed year.

In those difficult times, there was conflict between the debtor and creditor classes, which was in essence a regional conflict between the western (debtor) states and eastern (creditor) states. Supporters of remonetization were both inflationists

The Coinage Act of 1873, which abolished production of the standard silver dollar, was called the “Crime of 1873” by the Free Silver movement. Pictured is a Seated Liberty (standard) dollar dated 1873 and struck at the Philadelphia Mint.



Silver miner working inside the Comstock Lode, Virginia City, Nevada. Massive production of silver at the Comstock resulted in the price drop of silver beginning in 1873. This was a contributing factor to the advent of the Free Silver movement.

and contractionists; greenbackers and anti-greenbackers. Among them were numerous groups of farmers, businessmen and bankers, as well as politicians, publishers and publicists. This diverse mix of Americans shared a general hostility towards the new industrialized society, which modernized older economic activities. This included the demonetization of silver and the elimination of the silver dollar itself. Weinstein writes, “The drive to restore silver as a monetary standard derived this broad appeal not from economics alone, but from its compelling moral symbolism.”

Slogans employed by the Free Silver movement referred to the restoration of the bimetallic double standard as “an act of justice”: *restore* legal bimetallism,

remonetize the dollar of the daddies, *redress* the “Crime of 1873.” It became an ideology, at times resembling a religion. This affection for silver coinage served as a symbolic link for Americans from different classes, regions and political beliefs who marched together to support silver remonetization during the late 1870s. This movement had broad popular appeal in every region except New England.

The Opening Salvo of Free Silver

On March 2, 1876, the *Boston Globe* published a letter written by George M. Weston. His letter sparked the Free Silver movement. Irwin Unger, author of *The Greenback Era: A Social and Political History of American Finance*, writes,

“Weston’s most arresting—and ultimately most fertile—idea was the notion that the 1873 demonetization of silver was a plot to defraud the American people for the sake of the creditor interests.” Despite the fact that bimetallism had never worked in America, Weston asserted that the double standard had prevailed until the Coinage Act of 1873.

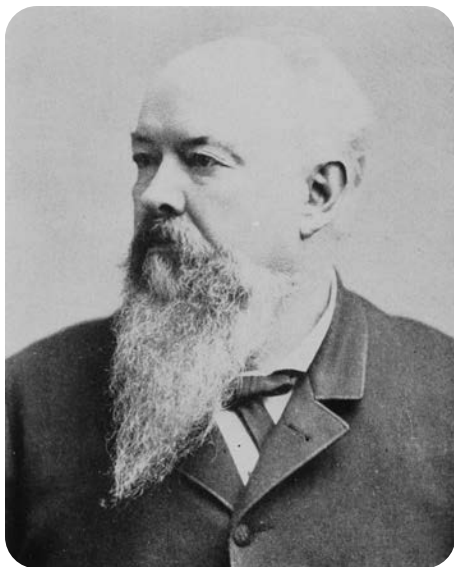
Weston writes that the 1873 Coinage Act and the later 1874 law that formally demonetized silver, “was as selfish in its origin as it was surreptitious in the manner of its introduction.” It was “the most flagrant and audacious of the manifestations of the control exercised by foreign and domestic bankers over national legislation in the recent and evil days.”

His conspiracy theory was baseless. Nothing was conniving about the demonetization of silver. Weston was on the right track, however, when he pointed out that removing silver coin from the legal tender deprived Americans of an important means of relief from the difficult burden of public debt. “The people who are to pay this debt, and who received nothing for it but depreciated paper, are entitled to the benefit resulting from the richness and abundance of newly discovered silver mines.”

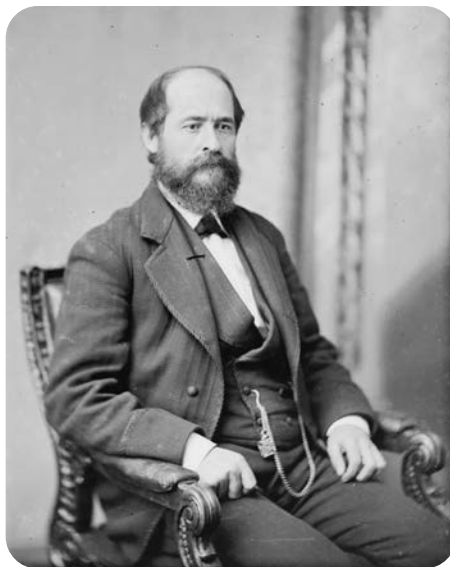
Weston’s March 2 letter was the opening salvo in public debate on the silver issue. Within weeks after it had been published, his comments had been reprinted, praised and criticized in newspapers in Boston, New York, Chicago and San Francisco. Over a dozen articles by Weston were published during 1876 in prominent dailies and periodicals. Weinstein writes, “Weston, more than any other single individual, helped stimulate public interest in the silver question through his writings.”

The “Sole Western Apostle of Bimetallism”

Senator John Percival Jones of Nevada was the lone mining state legislator in Congress who vigorously supported remonetization during the Free Silver drive of 1876 to 1878. Weinstein writes, “Jones served as the sole western apostle of bimetallism in the congressional struggle which opened in April 1876, helping to propagate doctrines later identified with the entire mining West.” The silver question first emerged as a national issue and debate with Jones’s initial fiery speech on the issue in April 1876.



Senator John Percival Jones of Nevada. The silver question first emerged as a national issue and debate with Jones's first speech on the issue in April 1876.



Congressman Richard Bland of Missouri, who wrote the Bland bill, which eventually became the Bland-Allison Act of 1878.



Senator William Allison of Iowa, who removed the free silver provision and added the silver certificate clause to the Bland bill. That resulted in the Bland-Allison Act.

The senator called for restoration of bimetallism and that the \$5 legal tender be abolished for all silver coins, making them unlimited legal tender. On the Senate floor, Jones regularly promoted a permanent bimetallic standard and the immediate reinstatement of the 412.5 grain silver dollar—the “dollar of the daddies.” He became the most influential congressional supporter of the double standard. During the two years between his opening speech on the subject and passage of the Bland-Allison Act, Jones served as chairman of the congressional monetary commission that was appointed in August 1876 to discuss the silver question.

Pro and Con on the Silver Question

The potential return of bimetallism was attractive to businessmen who were against further contraction of the money supply while the Long Depression lasted. There were many pro-resumptionist, hard money newspapers that felt the end of legal tender silver coins after 1873 had been a major reason for the drawn-out business slump.

Most of New York's national bankers were dead set against the double standard. Before the election of 1876, the New York and San Francisco Chambers of Commerce, the Boston Board of Trade and the executive committee of the National Board of Trade had all petitioned Congress “against making silver coin an unlimited legal tender.”

Western merchants supported the Free Silver movement, seeing restoration of the double standard as a productive way of expanding the circulating stock of hard money. The Cincinnati and St. Paul-Minneapolis Chambers of Commerce petitioned Congress for remonetization of silver, and a majority of midwestern business associations were favorable towards silver during the controversy. In 1877, James A. Garfield's opposition to bimetallism cost him “almost unanimous” support of Ohio's business community in his bid for the Senate.

During 1876, there were mixed responses to the silver question among financial experts, manufacturers and others. A passionate war of words over silver policy began among economic publicists, liberal Republicans, genteel reformers and other elements of the intelligentsia. Newspaper response to the bimetallism crusade did not divide along sectional lines. For example, there were hard money bimetallists who saw remonetization as a method of sparking economic recovery.

Businessmen and business publications disagreed on the question of remonetizing silver, and the academic reform community and the nation's hard money newspapers were also without consensus on the controversy. Newspaper editors, bankers, economists and businessmen from around the nation advocated for the “dollar of the daddies” several months before southern and western agrarians

discovered the silver issue. It took until mid-1877 for a mass movement that supported remonetization to spread, cutting across party and class distinctions.

Within the Free Silver movement were those who desired inflation. They felt that free silver would increase the money supply and inflation, which would mean prices would rise on goods, more money would be available for credit and debtors would be able to pay off their debts more inexpensively.

Passage of Bland-Allison (1878)

The Bland silver bill, named after Representative Richard P. Bland of Missouri, which passed the House in November of 1877, had the intention of re-establishing the bimetallic double standard. This bill included the unlimited coinage of silver via the “free silver” provision. However, the amendments proposed by Senator William B. Allison of Iowa in the Senate Finance Committee were adopted, removing the “free silver” coinage provision.

Replacing it was a requirement that compelled the Secretary of the Treasury to purchase, at the current market price, a minimum of \$2 million and a maximum of \$4 million worth of silver bullion each month. That bullion was to be struck, as fast as possible, into silver dollars. The Bland-Allison Act became law on February 28, 1878, after a congressional override of President Rutherford B. Hayes' veto the



A \$10 silver certificate carrying the image of Robert Morris, issued in 1878. Since silver dollars rarely circulated, silver circulated almost exclusively in the form of paper silver certificates.

same day. The Act was in effect until 1890.

Economist Neil Carothers writes, “This famous law was not a free-coinage measure, or a bimetallic measure, or a change of standard measure. It was a subsidiary coinage law.” So, after two years of non-stop agitation by the silver movement to “restore legal bimetalism,” they ended up with a continuation of the gold standard. Nonetheless, they did get the “dollar of the daddies” they demanded, which was called the “Bland dollar” at the time.

What makes Bland-Allison unique is that never before did the US government purchase gold or silver bullion wholly

with its income. It never did for gold what it did for silver. Economist J. Laurence Laughlin writes, “This mechanical and forced coinage of fixed amounts of silver each month, irrespective of the desires of the business community or the needs of exchange, was flying in the face of the principal of demand and supply. The legislators in 1878 had committed to repeal the laws of demand and supply.”

The Provision for Silver Certificates

Another important amendment by Allison was the provision for silver certificates.

Laughlin writes, “In its after-effects, this provision proved more effective in carrying out the purpose of the advocates of silver than it was expected...” The provision states:

That any holder of the coin authorized by this act may deposit the same with the Treasurer or any assistant treasurer of the United States, in sums not less than \$10, and receive therefor certificates of not less than \$10 each, corresponding with the denominations of the United States notes. The coin deposited for, or



A Bland dollar (now called the Morgan dollar) dated 1878-S (San Francisco Mint). This example has been authenticated and certified as Specimen-65 by Professional Coin Grading Service as the earliest-known branch mint proof Morgan dollar.

representing, the certificates shall be retained in the Treasury for the payment of the same on demand. Said certificates shall be receivable for customs, taxes, and all public dues, and, when so received, may be reissued.

Radical Shift in Monetary Policy

The Bland-Allison Act was a radical departure from the monetary policy of previous years. Except for the paper money era of 1862–1879, the United States had expressed prices and contracts—both actually and legally—in the gold standard since the year 1834. The silver bullion purchases authorized by Bland-Allison were to be struck into dollars each containing 371-1/4 grains of pure silver (or 412.5 grains standard silver). These dollars were to be “a legal tender at their nominal value for all debts and dues, public and private except where otherwise stipulated in the contract.”

The Act of 1878 brought a new currency to America. Objections to the use of silver dollars, due to their weight and bulk, were mostly removed by the provision for silver certificates. Those certificates were not a full legal tender for all debts—“public and private”—as silver dollars were. However, in practice they were received equally with silver dollars, for, if refunded, one could easily acquire silver dollars.

Suspicion of Silver

There was much distrust of silver in the two years after the passage of Bland-Allison. The silver dollars stockpiled in the Treasury nearly as quickly as they came from the mints. The only way to keep silver in circulation was via silver certificates. Among the first issues were denominations of \$1,000. They were employed to acquire bullion in San Francisco and then they were sent back to New York in 10 days, where they were used for customs payments to the US Treasury. Those certificates were held only by large firms or banks. There were also silver certificates in denominations of \$10 and \$20.

Between June 1878 and mid-1880, the vast majority of silver dollars remained in the Treasury. Few silver certificates were issued during this time. However, in September 1880, a favorable method for getting out silver was devised. Drafts were offered on the sub-treasuries in the West and South, payable in silver certificates to those who wanted to make their payments there, in exchange for gold coin deposits at the New York subtreasury. In essence, it was a transfer of funds to far-off regions of the country free of charge.

Confidence In the Gold Standard Shaken

The overall revival of trade after the resumption of specie payments in 1879 saw great

prosperity in the early 1880s. Gold was imported and gold reserves in the Treasury saw the results in a larger inflow during 1881. There was an increase in bank circulation, and denominations of money—for example \$10 and \$20—for use in the retail trade, were needed in large sums.

However, during this time the gold reserve was sensitive to increases in silver supplies in the Treasury. In 1880, when silver went up, gold dipped; in 1881, when silver dipped, gold went up; and, the end of 1882, as silver went up, gold dipped. Overall, as Treasury supplies of silver rose, the gold reserve fell.

Bland-Allison initiated a period in which confidence in the gold standard was shattered. That was due to the prospect of the change of standard from one metal to another. In 1885, Laughlin wrote, “The possible drop from a gold to a silver standard was full of startling uncertainties. This was the cause of the alarm felt by the business community, and it was a very real one. The great incubus hanging over the country since 1878 had been this fear of a change in our standard.”

The Panic of 1884

The Panic of 1884 struck in the midst of the Depression of 1882–1885. Failures in May 1884 led to restricted production



Bland dollars in 1,000-coin canvas bags in a vault of the US Treasury in 1914. Hundreds of millions of Bland dollars did not circulate.

and decreased activity in all business sectors. The major supply of gold arrived at the Treasury via customs, and New York received the majority of such payments. However, gold payments started to fall off starting in September 1883, while greater percentages of silver and greenbacks were collected. By the end of 1884, gold receipts had dipped to 20%, in comparison to 80% in 1883. On the other hand, receipts of silver rose from 15% in 1883 to 45% in 1884.

Large surpluses had previously enabled the government to pay off several millions of national debt each year. However, in September 1884 the government simply stopped paying off the national debt. “Here was another effect of the silver legislation of 1878,” writes Laughlin, “It crippled the patriotic payment of our public debt. Instead of being used in reducing the interest-bearing burden, our surplus was used in purchases of silver, which not only could not be got out of the Treasury, but prevented gold from coming in.”

Forcing Silver Dollars into Circulation

In 1885, a vacuum in currency circulation was created to force silver dollars into circulation. To that end, the issuance of bank notes under \$5 was halted in June 1885. Thus, silver dollars were required for change for larger purchases. This resulted

in a rise in circulation of silver dollars during the second half of 1885 and in 1886.

Laughlin describes “the increase of silver circulation in and after 1886...” However, that was mostly in the form of silver certificates. The circulation of silver dollars averaged around 40 million in 1884 and at the end of 1886 topped out at just over 60 million pieces. The circulation of such coins hovered around 60 million annually from then until 1892, after which time it began to dip slightly.

Arthur B. Woodford writes, in 1893, “Nearly 400,000,000 were coined under [the Bland-Allison] act, of which 60,000,000 remain in circulation...” That figure represents about 15% of the mintage from 1878 to 1893. But where did most of the silver dollars circulate? Carothers writes, “The general public rejected it. The negligible population of the West, for partisan purposes, accepted the coin, as did the southern [former slaves], whose inability to read led them to reject printed bills.”

Increasing Silver Circulation Via Silver Certificates

A rider to the General Appropriations Act of June 30, 1886, authorized the issuance of silver certificates in denominations of \$1, \$2 and \$5. Therefore, silver certificates replaced small denominations

of greenbacks and the withdrawn bank issues. After the end of the Depression of 1882 to 1885—from 1886 to 1890—payments of gold flowed into the Treasury and the gold supply was more than sufficient. However, as discussed, the “Bland dollar” rarely circulated and a few hundred million of them were stashed away in Treasury vaults. The extensive circulation of silver certificates was the only way to keep silver in everyday commerce. \$

Eric Brothers is a regular contributor to Numismatic News. Since 2006, he has written 46 features for The Numismatist, the publication of the American Numismatic Association (ANA). He also writes for FUNTopics, the publication of Florida United Numismatists, and ANS Magazine, a publication of the American Numismatic Society in New York. This is his seventh article for Financial History.

Note

1. “Free Silver” is when anyone could bring unlimited silver bullion to the US mints and have it coined into whatever coin they wished—without a seigniorage charge.

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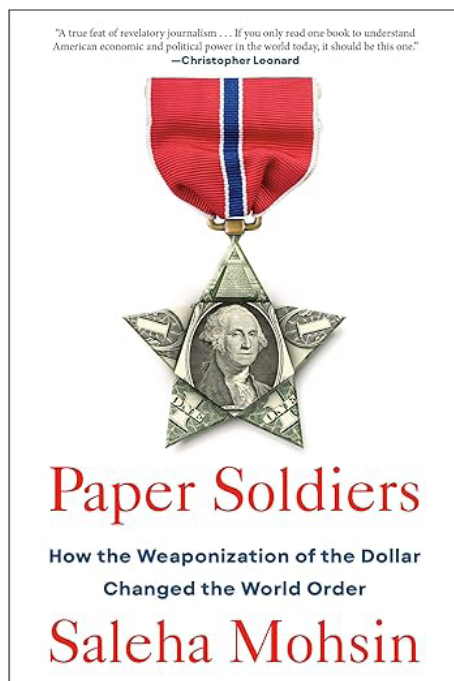
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Paper Soldiers

By Saleha Mohsin

Portfolio/Penguin, 2024

282 pages, with notes and index

THERE ARE A LOT of important dates in US financial history: August 4, 1790 (Hamilton's debt assumption); March 10, 1862 (first US greenback); December 23, 1913 (creation of the Fed); October 29, 1929 (that one's easy). At the time, it's likely most people did not grasp the full impact of the events of the day. Maybe Hamilton did, but in most cases, we don't know they're important until long after.

Author Saleha Mohsin, relying on her experiences and contacts as a Bloomberg News reporter covering the US Treasury, wants you to mark down a more current date: February 26, 2022. According to her, that is when the primacy of the US dollar as the world's reserve currency may have started to erode. Her book, *Paper Soldiers*, reviews events of the last 30 years or so that have shaken confidence in the dollar. She argues that, drip-by-drip, actions by US politicians and officials have worn down belief in the dollar as a stable, safe and, most importantly, neutral unit of exchange upon which global market participants and governments can rely. She's

interviewed a wide range of US officials, and the book adds a different perspective to the issue. It's a fast, well-written read.

Trillions of financial and physical assets—most importantly corporate and sovereign bonds—are denominated in dollars. They are sold in dollars, valued in dollars and payable in dollars. No surprise: this creates an almost insatiable demand for the dollar.

This all happened over the 80 years since the 1944 Bretton Woods agreement, when the dollar supplanted the British pound as the world's most desirable currency. Being the world's reserve currency is undeniably a good thing. It allows a lot of flexibility. And when you have to finance US government debt on an hourly, daily and yearly basis, it is an advantage. But it carries costs and takes discipline to maintain the confidence of global players.

After some desultory backgrounding, Mohsin's story really starts in the 1990s, with President Bill Clinton and his second Treasury Secretary Robert Rubin. Rubin was a calm, hard-to-read Treasury head who understood that loose talk about where the dollar or any currency "should be" was not helpful. Finally, he arrived at a policy formulation expressed in simple terms. "A strong dollar is in our national interest" became his mantra, repeated and repeated until the markets and foreign governments got the message. President Clinton presided over a powerfully growing economy and did something rare: he balanced the US budget.

What Clinton and Rubin perhaps didn't see, writes Mohsin, is that a strong dollar, NAFTA and a more market-friendly Chinese leadership would create fundamental dislocations in the US business environment. US manufactured goods became very expensive to buy, and it was cheaper and faster to shift production to China and elsewhere than to invest in the United States. Accusations grew that China was purposely weakening its own currency to speed this process. The idea caught on that the United States should do more to use its currency hegemony to help itself.

Mohsin shifts the narrative as the world wakes up to the terrorist attacks on September 11, 2001. The reader is taken on a brief but useful tour of the "plumbing"

of the global financial system. Enemies need money—the US Treasury, Department of Defense and Homeland Security understood this—and began to monitor dollar flows at SWIFT, a little-known international agency at the nexus of international payment and currency flows. It was another weapon that promised to enhance US security and impede terrorist activities.

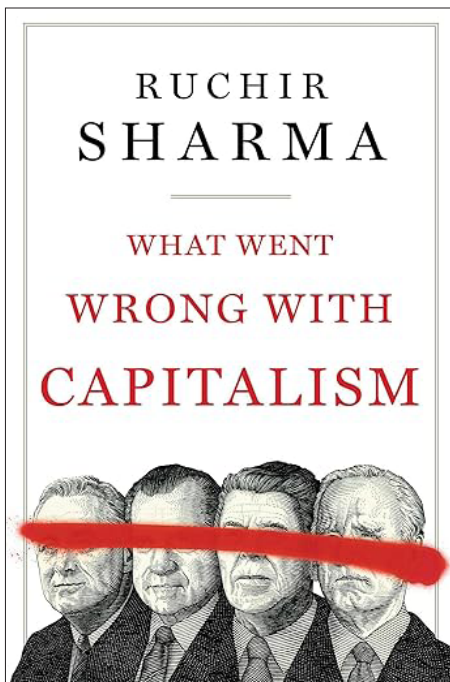
As the 2010s progressed, using the financial system to impose sanctions looked more and more attractive as a policy: a cheap and painless way to punish enemies. It generates great headlines and looks like modern warfare. Presidents Barack Obama and Donald Trump embraced sanctions. Libya, Iran and Russian oligarchs were all targeted with this arrow in the US quiver. Treasury officials, however, were more judicious, warning that indiscriminate use could bring the dollar's status into disrepute.

Paper Soldiers reads like a newspaper piece, which I think is a good thing. I learned more than I needed to about Paul O'Neill and John Snow, two forgettable Treasury Secretaries. Clearly, Mohsin is a Paulson-Geithner fan. Many are. I wish there was an acknowledgement and exposition that for all our currency power, North Korea, Syria, Iran and Russia, although weakened, are still around. And are threatening.

February 26, 2022 was just two days after Russia launched its failed takeover of Ukraine. The United States began to move forward on the process of closing down Russian access to its own financial assets located outside Russia. US power to control the global financial system was never more evident. Governments opposed to US policy began to agitate for a new reserve currency that was free from US control.

So, is the dollar ready to take its place with the British pound? Is the world ready to move to a world denominated in yuan or rubles—or bitcoin? I doubt it. Mohsin doesn't draw any hard conclusions. But the sunset might have already started. 💵

James P. Prout is former SEC lawyer with more than 30 years of capital market experience. He has been reviewing books for Financial History since 2009. He is now a consultant to some of the world's biggest public companies.



What Went Wrong with Capitalism

By Ruchir Sharma

Simon & Shuster, 2024

368 pages, with notes and index

In *What Went Wrong with Capitalism*, Ruchir Sharma makes several important points, most notably that the twin policies of endless and essentially free money, and an effectively permanent bailout culture are drowning capitalism in its own excess. He makes strong arguments in support of those theses, so it is odd that he mostly does so in the second section of the book.

Sharma states his case on page six. “Capitalism has been twisted into an unfair and inefficient form, but not mainly by rules stacked in favor of big companies and tycoons. It has been distorted above all else by governments and central banks pumping more money into the economy than the markets can possibly invest effectively.”

As a 22-year veteran of Morgan Stanley Investment Management and the founder of Breakout Capital, Sharma clearly has an authoritative perspective on that. With a sly reversal of the favorite boogeyman for most conservatives, he continues, “More than just socialism for the very rich, the underlying issue is socialized risk for

everyone—the government extending the safety net beyond the poor to the middle class and the rich, at a pace and scale that have corrupted capitalism with debt.”

Having staked his claim and established a refreshingly forthright premise, however, the very next sentence falls back into the broad generalization that “bigger government will only magnify the distortions.” And then we don’t really get to the meat of the message again until section two.

The first section of the book mostly reiterates common gripes, such as the hoary assertion that over-regulation is stifling innovation. Sharma has a sterling publishing reputation, and such good ideas that he presents clearly, it is a shame he feels he must ride over so much well-trodden ground first. Even if he were just damning free-market tropes with faint praise, we don’t need 150 pages of that.

To be sure, there are a few gems in the first section, including “economic growth is a simple function of how many people are working and how much each worker produces.” That would have been a great opening to a broader exploration of how the explosion of the gig economy and online retailers have distorted the nature of work.

“Instead of raising productivity and with it economic growth, government money has flooded into financial engineering projects—buyouts, share buybacks and other strategies to boost stock prices, not build anything new,” Sharma states emphatically. “In the past, financial markets typically reflected and followed the economy up and down. Now they float only upward, levitating on a magic carpet of stimulus. It is a fine time for the wealthiest investors, who are often of advanced age, but a frustrating time for the working middle class and the young.”

That is a clear and compelling clarion call, and a powerful distillation of what has gone wrong with capitalism. It should be in the opening chapter of the book. But it isn’t. We don’t get to it until chapter 13, page 211.

Sharma opens chapter 14 with this insight: “If you had to pick one explanation for why so many people are so unhappy with capitalism, the rise of inequality would be a popular choice.

Billionaires make for a fat target. But the fall in productivity is the more subtle and persuasive one.”

He continues, “When each worker produces more, companies can raise wages without raising prices. The economy can grow without generating crippling inflation. The economic pie can grow steadily for everyone. If productivity is falling, as it has been for the last two decades, more and more people will be fighting for what’s left.”

Sharma explains that “productivity growth is the number that reveals whether capitalism is working. Its broad decline over the last five decades—a period of technological progress—has been called the Solow Paradox, after Nobel laureate Robert Solow.”

That is great stuff, both insightful and beneficial. So why is it buried on page 231? Just a few pages later we find the paragraph that should be the conclusion of the entire work: “Easy money is fueling the rise of two very different symptoms of dysfunction, powerful oligopolies and pathetic zombies [companies and banks], and both have a similar impact on the health of the system. They squeeze the life out of small- and medium-size companies, which were once the key drivers of productivity growth.”

Sharma stresses throughout the book that real production—actually making goods or providing essential services—is elemental to a strong economy. He is highly critical of the vast swaths of business that don’t actually produce anything, they just exist to move around massive volumes of money.

He is also highly critical of large technology companies. “If money corrupts, then what Wall Street now calls the ‘super-normal profits’ of big tech will tend to corrupt absolutely. Sitting on cash piles in the tens of billions, the tech giants now have myriad options for stifling smaller rivals and undermining the process of creative destruction, which should be eroding their own dominant positions.”

Sharma cites several instances of big tech simply stealing innovations, “and if the victims dared object in court, they could be easily smothered in motions launched by a large army of lawyers.”

That, however, is the closest the author ever comes to addressing the drag that weaponized litigation has on the broader economy. Sharma is properly scathing about how pharmaceutical companies insulate themselves from competition by creating patent thickets. But nowhere does he mention the role of aggressive plaintiff attorneys in driving up the costs of health care and insurance.

There is a short third section of the book, which is interesting, but seems

bolted on. It highlights countries “where capitalism still works.” This includes Switzerland, Taiwan and Vietnam. They are all fascinating little case studies, but also all very specialized places—economic Petri dishes for which the applicability to a geography and economy as vast and varied as the United States seems largely theoretical.

Rushir Sharma is an excellent writer with deep professional experience. He has produced a book that presents some

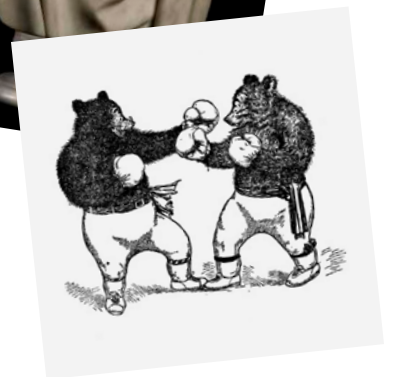
important iconoclastic ideas that are all the more bracing coming from a career insider. It’s a bit frustrating, then, that he’s partially hidden his light under a bushel, putting most of the good stuff in the second part of book. \$

Gregory DL Morris is an independent business journalist, principal of Enterprise & Industry Historic Research and an active member of the Museum’s editorial board.

TRIVIA QUIZ

HOW MUCH DO YOU KNOW ABOUT FINANCIAL HISTORY?

1. In what state was the secret meeting of bankers held that led to the creation of the Federal Reserve Bank?
2. What company, founded in 1946, was the first private venture capital (VC) firm in the United States?
3. How many Canadian banks failed between 1924 to 1982?
4. Who won the 1990 Nobel Prize in Economics for his pioneering work on portfolio management?
5. What is the nickname for the macroeconomic period, which lasted from 1965 to 1982?
6. What was the first mutual fund, founded 100 years ago on March 21, 1924?
7. What senator from Vermont is most responsible for the Union’s successful revenue program during the Civil War?
8. What 1878 Act required the US Treasury to buy and circulate silver dollars to increase the money supply?
9. The 1973–1974 bear market was the second longest in the post-war period. What was the longest bear market?
10. What is currently the nation’s largest financial industry?



1. Georgia
2. Advanced Research and Development (ARD)
3. Zero
4. Harry Markowitz
5. The Great Inflation
6. Massachusetts Investors Trust
7. Justin Smith Morrill
8. The Bland-Allison Act
9. The 31-month slump between March 2000 and October 2002
10. Mutual funds

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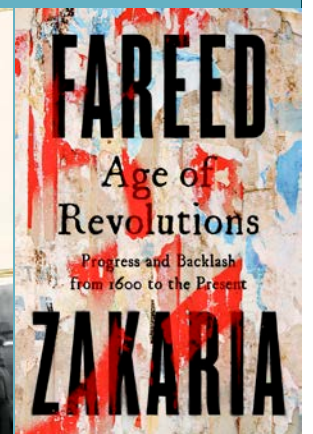
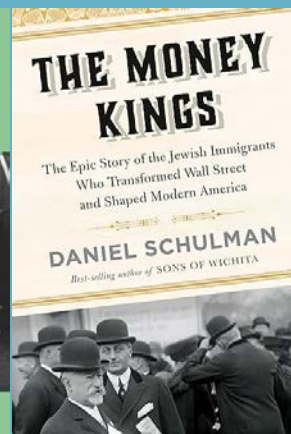
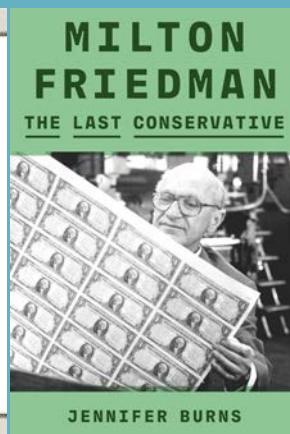
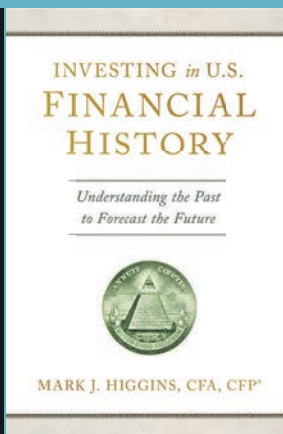
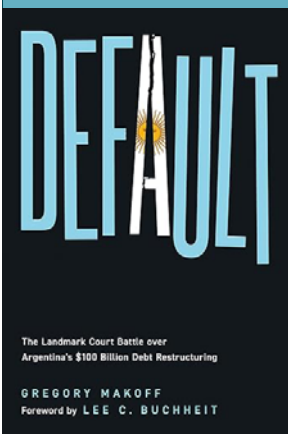


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